No. 92-267

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1992

UJB FINANCIAL CORP., et al.,

Petitioners,

against

IRWIN SHAPIRO, ROBERT BASSMAN, JEROME KATZ, NORMAN SALSITZ, JEAN LEE, and CHAPPAQUA FAMILY TRUST,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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August 12, 1992

QUESTIONS PRESENTED FOR REVIEW

1. Did the Third Circuit err in announcing a new, "relaxed" application of Rule 9(b), Fed. R. Civ. P., which

    - flatly conflicts with the standards of the First, Second and Seventh Circuits, as well as the standard previously established by the Third Circuit (including as applied by a different panel of the Third Circuit on the same day); and

    - is so "relaxed" that, in effect, it eviscerates Rule 9(b)'s express, heightened pleading requirement and equates it with Rule 8's "notice pleading" standard?

2. Is any statement made by management "addressing the quality of a particular management practice" material merely by virtue of addressing same, as the Third Circuit stated, despite this Court's contrary determination in *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988) (not cited by the Third Circuit) that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information"?

RULE 29.1 STATEMENT

The parties to the proceedings below were the petitioners, UJB Financial Corp., T. Joseph Semrod, Clifford H. Coyman, John R. Haggerty, Robert L. Boyle, Elinor J. Ferdon, Walter L. Dealtrey, Fred G. Harvey, Francis J. Mertz, Henry S. Patterson II, James A. Skidmore, Jr. and Joseph M. Tabak and the respondents Irwin Shapiro, Robert Bassman, Jerome Katz, Norman Salsitz, Jean Lee, and Chappaqua Family Trust.

UJB Financial Corp. has no subsidiaries (except wholly-owned subsidiaries) or affiliates as those terms are used in Supreme Court Rule 29.1.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Third Circuit is reported at 964 F.2d 272 (3d Cir. 1992). The Third Circuit's slip opinion dated May 20, 1992 is reproduced at Appendix I A-1-35. The Third Circuit's denial of defendants' request for rehearing or rehearing in banc dated July 7, 1992 is reproduced at Appendix I A-51-52. The transcript opinion of the United States District Court for the District of New Jersey (Thompson, J.) dismissing, in part, the Complaint is reproduced at Appendix I A 38-50.

JURISDICTION OF THIS COURT

The judgment of the Court of Appeals was entered and filed on May 20, 1992 and rehearing was denied by the Court of Appeals on July 7, 1992. The judgment may be reviewed by this Court by writ of certiorari granted under 28 U.S.C. § 1254(1) (1988). This petition for a writ of certiorari to review the judgment of the Court of Appeals, having been filed within 90 days after the entry of the judgment and denial of rehearing, is timely under 28 U.S.C. § 2101 (c) and Supreme Court Rule 13.

STATUTE AT ISSUE

- Rule 9(b), Federal Rules of Civil Procedure:

> **Fraud, Mistake, Condition of the Mind.** In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally.

STATEMENT OF THE CASE

A. Nature of the Case

This action (one of dozens which have been filed against banks in the Northeast in the past three years) arises out of the fact that the price of UJB Financial Corp.'s ("UJB") stock—like that of so many banks—declined substantially as the country slid into a recession. As a result of the recession, UJB, like other banks, faced increases in borrower defaults and declines in the value of collateral securing bank loans in the period immediately predating the Complaint.[1] The Complaint is premised upon plaintiffs' conclusory allegations (pleaded entirely on information and belief) that supposedly, UJB and eleven of its directors, including eight outside directors who were members of its audit committee, deliberately overstated the adequacy of UJB's lending practices and provided inadequate reserves for loan losses in the pre-recession period. Plaintiffs' claims are based on nothing more than the effect which the severe economic downturn, particularly in the Northeast, had on the financial condition of UJB, as well as so many other lenders.

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1. *See, e.g.*, Barbara Franklin, *The Recession's Upside*, N.Y.L.J., Feb. 14, 1991, at 5 (reporting that "[m]any" suits "target . . . banks for allegedly understating information on bad loans," and noting one lawyer's observation that "[e]veryone who has announced increases in loan loss reserves has been sued"); Doug Bailey, *Law Suits A Way Of Life For Banks*, Boston Globe, July 5, 1990, at 57 (reporting that "[s]ince last year, when the fortunes of all of the region's banks began [sic] to sag, shareholders and their attorneys have pounced, filing a slew of class action lawsuits charging that the banks should have foreseen, and publicly warned about, the tough times ahead," and observing that "the same group of lawyers have [sic] brought virtually all the suits, which use the same 'boilerplate' language, from the same master form"). Indeed, over 50 such "cookie cutter" complaints were filed against banks other than UJB in 1990 alone. *See, e.g.*, *FDIC Says Real Estate Slump In Area, Northeast Is Weakening U.S. Banks*, The Washington Post, Sept. 7, 1990, at A1; *Financial Loss: Big Banks Are Plagued by a Gradual Erosion of Key Profit Centers*, Wall St. J., Aug. 1, 1990, at 1 col. 6; *Real Estate Crisis Takes Toll of U.S. Banks*, Financial Times, May 11, 1990, at 33.

Plaintiffs' contentions (which defendants vigorously deny) reflect a classic example of the long-condemned practice of alleging fraud by "20-20 hindsight." Plaintiffs have seized on UJB's public announcements in 1990 that it had increased its loan loss reserves and had written off certain loans in whole or in part—which one would consider quite prudent and appropriate under the circumstances of a declining economy—as a basis for alleging that the level of loan loss reserves established in prior periods (1987-89) were fraudulently understated and that UJB's statements in that pre-recession period as to the propriety and prudence of its lending policies were false. Ignoring the well-publicized change in the economic climate between the earlier and later periods—and that loans that were prudent and well-secured when made may have to be written down, and reserves for possible losses increased, if a recession later occurs and borrowers' businesses are adversely affected and the value of the lender's collateral (such as real estate in the Northeast) plummets—plaintiffs contend in purely conclusory terms, and without pleading any facts, that the earlier disclosures were false.

Plaintiffs have not identified, in the 1987-89 period in issue, a single UJB loan or category of loans that was under-reserved, a single method or standard by which reserves should have been, but supposedly were not set, a single loan that UJB improperly failed to write-off, a single lending practice that was inappropriate, or a single fact demonstrating that any defendant (eight of whom are outside directors) at any time acted with scienter. Plaintiffs are unable to do so because they have no facts that support their allegations of fraud. Indeed, when the district court offered them the opportunity to replead— which would have been easy enough to do if they had any facts to support their glib charges of fraud—plaintiffs declined to do so. Rather, plaintiffs appealed; the Third Circuit reversed the District Court and announced a new standard of pleading fraud pursuant to Rule 9(b), Fed. R. Civ. P. As discussed below, such standard conflicts with the standards established by other Courts of Appeals and by the Third Circuit itself in prior caselaw. In addition, the Third Circuit stated that "[b]y addressing the quality of a particular manage-

ment practice, a defendant declares the subject of its representation to be material." *UJB*, 964 F.2d at 282 (A-18). This statement directly conflicts with this Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), which held to the contrary.

B. The Course of Proceedings

This action commenced with the filing of three separate complaints in April and May of 1990. These separate actions were consolidated with the filing of a single pleading (the "Complaint") on September 4, 1990. The district court's jurisdiction was based upon Section 22 of the Securities Act of 1933 ("Securities Act"), Section 27 of the Securities Exchange Act of 1934 ("Exchange Act") and upon 28 U.S.C. § 1332 (diversity jurisdiction). Despite filing four separate complaints, plaintiffs still have not alleged a single fact demonstrating or raising even a fair inference that the defendants made any misstatements, much less fraudulent ones.

The Complaint contained both class and derivative allegations and charged the defendants, a bank holding company and eleven of its directors, with violations of Sections 11, 12 and 15 of the Securities Act, Sections 10(b), 14(a) and 20 of the Exchange Act, rules of the Securities and Exchange Commission ("SEC") promulgated pursuant thereto, negligent misrepresentation, breach of fiduciary duty and waste of corporate assets. All such claims were based upon defendant UJB's supposedly deliberate reporting of inadequate loan loss reserves and alleged overly optimistic or inaccurate statements as to the prudence of its lending operations and its internal management and credit controls. Defendants moved to dismiss all claims pursuant to Rules 12(b)(6) and 9(b), Fed. R. Civ. P.

The district court's well-reasoned and well-supported decision on the motion to dismiss is set forth in its Opinion, dated January 22, 1991 (annexed as Appendix ("A") I hereto, at A-38). (On February 15, 1991, the district court issued its Order embodying its decision). After parsing out and carefully analyzing plaintiffs' allegations, the court dismissed, without leave to amend, pursuant to Rule 12(b)(6), certain portions of plaintiffs' claims under Section

10(b) of the Exchange Act and Sections 11 and 12(2) of the Securities Act as sounding in mismanagement, not actionable under the federal securities laws (A-43). It denied the motion under Rule 12(b)(6) as to the claims under Sections 14(a) and 20.

With respect to so much of the misrepresentation and omission claims under Sections 10(b), 11 and 12(2) as were not dismissed pursuant to Rule 12(b)(6), the district court properly found that such claims did not satisfy the pleading requirements of Rule 9(b), but it did not dismiss those claims. Instead, the district court granted plaintiffs leave to replead, and ordered that if plaintiffs did not replead, the court would entertain a renewed motion to dismiss (A-50). In applying Rule 9(b) to the allegations of this Complaint, the district court followed the Third Circuit's earlier decisions in *Christidis v. First Pennsylvania Mortgage Co.*, 717 F. 2d 961 (3d Cir. 1983), and *In re Craftmatic Securities Litigation v. Kraftsow*, 890 F.2d 628 (3d Cir. 1989) (as well as decisions of the Second Circuit in *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978), and the Seventh Circuit in *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990)). The district court found that while plaintiffs had alleged the "who, what and where" elements of a fraud claim with sufficient particularity, the plaintiffs utterly failed to indicate "how" the statements allegedly were misleading (A-49).[2]

The Third Circuit affirmed in part and reversed in part the district court's decision (964 F.2d 272 (3d Cir. 1992), reprinted at A-1 herein). In the portion of the opinion which is the subject of this petition, the Third Circuit reversed the district court's decision to the extent it held portions of the Complaint insufficient under Rule 9(b), and it announced a new, "relaxed" standard (id. at 285 (A-24))

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2. The district court also dismissed pursuant to Rule 12(b)(6), plaintiffs' Section 11 and 12(2) claims for failure to plead all the elements of those claims. The negligent misrepresentation claim and purported derivative claims also were dismissed. (A-48).

for pleading fraud under Rule 9(b).[3] The pleading standard announced by the Third Circuit is in conflict with the pleading standard in the First, Second and Seventh Circuits, the Third Circuit's own earlier decisions, and the decision of another panel of the Third Circuit decided the same day as the instant case, which affirmed the dismissal of a virtually identical complaint. *See Decker v. Landmark Sav. Ass'n*, No. 91-3776 (3d Cir. May 20, 1992) (reprinted, along with other decisions which are not reported officially or available on Westlaw, in Appendix II, hereto, at AII-6); *Romani v. Shearson Lehman Hutton*, 929 F.2d 875 (1st Cir. 1991); *DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir. 1990); *Denny v. Barber*, 576 F.2d 465 (2d Cir. 1978). The Third Circuit held that, under its new standard, all that is necessary to satisfy the requirements of Rule 9(b) is a statement that the facts needed to plead the alleged fraud with particularity lie solely within defendants' control and a delineation of "the nature and scope of plaintiffs' efforts to obtain, before filing the complaint, the information needed to plead with particularity." *UJB*, 964 F.2d at 285 (A-24). In view of its newly announced pleading standard, the Third Circuit afforded plaintiffs yet another opportunity to replead the claims which plaintiffs already had expressly declined to replead. *Id.*

In reaching its decision to reverse the district court's dismissal of certain of plaintiffs' allegations as merely reflecting mismanagement, and not material misstatements, the Third Circuit further stated that simply by commenting

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3. The Third Circuit, elsewhere in its opinion, agreed with the district court that certain of the allegations did not state a claim under the federal securities laws since they constituted mere puffing, failure to predict the future, or mismanagement (A-20-22). The Third Circuit reversed the district court's dismissal pursuant to Rule 12(b)(6) of certain other portions of the Complaint (finding that such portions did allege misrepresentations rather than merely mismanagement). It also reversed the dismissal pursuant to Rule 12(b)(6) of the Section 11 and 12(2) and negligent misrepresentation claims (A-25-35). The Section 14(a) claim was withdrawn with prejudice by plaintiff Chappaqua, subsequent to the filing of the appeal to the Third Circuit, in an effort to create a final decision subject to appellate jurisdiction.

on its operating or lending practices (e.g., by characterizing them as "prudent" or "conservative"), UJB "declares the subject of its representation to be material." *Id.* at 282 (A-18). The Third Circuit's statement on materiality in this regard (a point neither argued nor briefed to that court or to the district court) totally ignored the directly contrary holding of this Court in *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988).

The Third Circuit denied defendants' request for rehearing or rehearing in banc on July 7, 1992, but stayed the issuance of the mandate to allow defendants an opportunity to petition this Court for a writ of certiorari. The Third Circuit's decision has created an inter-circuit conflict (Point IA.), and an intra-circuit conflict (Point IB.) with regard to the requirements of Rule 9(b), and ignores the controlling authority of this Court (Point II) governing materiality of public statements; thus, certiorari should be granted to permit this Court to address two critical issues that arise in virtually every action alleging fraud in securities actions in federal court.

REASONS FOR GRANTING THE WRIT

I. THE DECISION OF THE THIRD CIRCUIT EVISCERATES THE REQUIREMENTS OF RULE 9(b), CREATES AN INTOLERABLE CONFLICT AMONG THE CIRCUITS, AND PERPETUATES THE EXISTING STATE OF CONFUSION AT THE DISTRICT COURT LEVEL

This petition brings to the Court a case on which to resolve a most significant procedural issue: the standard of pleading under Rule 9(b), which applies to every fraud case filed in every federal court and is implicated in literally hundreds of securities cases every year, including every action under Section 10(b) of the Exchange Act and SEC Rule 10b-5 (17 C.F.R. § 240.10b-5 (1992)) promulgated thereunder. The Third Circuit's decision in *UJB* announces a new, "relaxed" standard under Rule 9(b). This standard flatly conflicts with the pleading standards of the First, Second and Seventh Circuits, relaxes the Third Circuit's prior standard, and is inconsistent with the decision of another panel of the Third Circuit which affirmed the dis-

missal of a virtually identical complaint on the very same day. *See infra*, pages 20-23. Moreover, Rule 9(b) specifically imposes more stringent standards than Rule 8 "notice pleading" upon a plaintiff who wishes to assert fraud. The "relaxed" standard announced by the Third Circuit in *UJB* thus frustrates the express terms of Rule 9(b), as well as the important policies underlying that Rule, including: precluding strike suits by ensuring that a plaintiff has investigated and obtained the facts supporting fraud charges *before* filing suit; placing defendants on notice of the precise wrongdoing with which they are charged; and protecting the reputations of defendants from the harm which results from the mere pendency of a fraud action (*see infra*, pages 23-25).

This Court should grant petitioners' request for a writ of certiorari to address the conflict among the Circuits, within the Third Circuit itself, and the resulting confusion and inconsistency among the district courts. Review is particularly appropriate where, as here, the conflict involves interpretation of a provision of the Federal Rules of Civil Procedure which this Court has never addressed. *See*, *e.g.*, *Hanna v. Plumer*, 380 U.S. 460, 463 (1965) (granting certiorari "[b]ecause of the threat to the goal of uniformity of federal procedure posed by the decision below"); *Schlagenhauf v. Holder*, 379 U.S. 104, 112 (1964) (granting certiorari on issue concerning Federal Rule 35(a), finding it appropriate "to formulate the necessary guidelines in this area"); *Hickman v. Taylor*, 329 U.S. 495, 500 (1947) (granting certiorari to interpret Federal Rules 26 to 37 where there had existed "a great divergence of views among district courts").

The Third Circuit's newly-pronounced pleading standard under Rule 9(b) permits a plaintiff to prosecute a securities fraud action, despite plaintiff's inability to plead any facts demonstrating how any defendant's behavior departed from proper conduct, or how any defendant's statement was inaccurate (much less fraudulent), solely on the ground that such plaintiff claims to have been unable to uncover any such facts prior to the filing of a complaint. Such standard eviscerates Rule 9(b)'s requirement that fraud be pled with particularity. The Third Circuit's standard also subjects

defendants both to lengthy and costly pretrial discovery—particularly in actions such as this one, challenging a multi-billion dollar bank's lending and credit-monitoring practices and policies in its entire loan portfolio over a four-year period—which simply may confirm the absence of any such facts, and to subsequent summary judgment motion practice, rather than permitting dismissal at the pleading stage. Such a standard thus is irreconcilably in conflict not only with Rule 1, Fed. R. Civ. P. which states that the Federal Rules of Civil Procedure "shall be construed to secure the just, speedy, and inexpensive determination of every action," but also with the decisions of other circuits (and with other panel decisions of the Third Circuit) which have required that a plaintiff asserting a securities fraud claim must plead facts demonstrating *how* the alleged conduct was wrongful, even under a "relaxed" standard.

The inter-circuit conflict, discussed in Point IA.1. below, is crystal-clear. As the Seventh Circuit held in *DiLeo*, in affirming dismissal of a complaint which challenged certain financial statements as false based solely on subsequent financial statements which disclosed less favorable operations and earnings in later periods, "[b]ecause only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud." 901 F.2d at 627. The First Circuit likewise has noted that absent a standard under Rule 9(b) requiring the pleading of facts showing how or why prior financial statements were false, "the advent of a recession could be expected to trigger a multitude of complaints in which plaintiffs seek to impose liability for their financial disappointments based on entirely fabricated scenarios of fraud." *Romani*, 929 F.2d at 880. The Third Circuit's decision in *UJB* is contrary to the well-reasoned decisions of these courts, for it allows plaintiffs to "simply seize[ ] upon disclosures made in later annual reports and allege[ ] that they should have been made in earlier ones" (*Denny*, 576 F.2d at 470), a practice expressly rejected by the Second and Seventh Circuits in *Denny* and *DiLeo*.

The irreconcilable inter-circuit conflict without more,

makes this case eminently worthy of certiorari. As discussed in Point IA.2. below, however, the disarray among the district courts on the standard to be applied under Rule 9(b) adds an additional reason for this Court to grant certiorari. As illustrated below, the lack of uniformity among the federal district courts—even those within the same circuit or district—is compelling. For example,

- *Compare Hershfang v. Citicorp*, 767 F. Supp. 1251, 1257 (S.D.N.Y.), *reh'g denied*, No. 90 Civ. 8178 (MBM), 1991 U.S. Dist. LEXIS 13881 (S.D.N.Y. Oct. 1, 1991) (Rule 9(b) requires that facts be alleged that would generate an inference of guilty knowledge, and a bank's "sudden about-face announcement" is not sufficient to support inference of fraud) *with In re Chase Manhattan Corp. Sec. Lit.*, No. 90 Civ. 6092, slip op. at 4 (LMM) (S.D.N.Y. Aug. 1, 1991) (Rule 9(b) only requires that plaintiffs identify who made the alleged misstatements, when they were made and their contents).
- *Compare Fox v. Equimark Corp.*, 782 F. Supp. 295, 300 (W.D. Pa. 1991) (under Rule 9(b), plaintiff must allege facts suggesting how financial reverses were fraudulent; failure to "specify *how* Equimark knew the reserves to be inadequate or *why* it should have increased its reserves earlier" resulted in dismissal) *with Urbach v. Sayles*, 779 F. Supp. 351 (D.N.J. 1991) (holding that Rule 9(b) only requires allegations identifying the statements which plaintiff contends were fraudulent when made—relying on *In re Midlantic Corp. Shareholder Litig.*, 758 F. Supp. 226 (D.N.J. 1990), an opinion which the *Fox* court expressly declined to follow).
- *Compare Save-on-Surplus Pension Plan v. United Saver's Bancorp, Inc.*, 760 F. Supp. 971, 975 (D.N.H. 1990) (Devine, Ch.J.) (complaint satisfies Rule 9(b) by making extensive references to the statements alleged

to be false or misleading), *with* the same Court's subsequent decision in *Shields v. Amoskeag Bank Shares, Inc.*, 766 F. Supp. 32, 38 (D.N.H. 1991) (Devine, Ch.J.) (noting the "flood of securities fraud class action suits" filed recently, declining to follow *Save-On*, and deciding to adopt "the wisdom of the majority" of courts, which hold that Rule 9(b) requires that plaintiffs allege how statements were fraudulent when made).

As noted in Point B, even the decisions of the Third Circuit itself applying and interpreting Rule 9(b) are inconsistent.

A. Review Of The Third Circuit's Decision Is Compelled By The Conflicts That Exist Among The Circuits And The Resulting Lack Of Uniformity Among District Courts

1. Circuit Court Conflicts In Applying Rule 9(b)

Rule 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." The Courts of Appeals for the First, Second and Seventh Circuits have construed this particularity standard to require the identification of who, what, where, when *and how* the alleged misstatement was fraudulent. *See Romani*, 929 F.2d at 878; *Denny*, 576 F.2d at 470; *DiLeo*, 901 F.2d at 627.[4] These circuits have

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4. Numerous district courts have followed the sound reasoning of those decisions. *See, e.g.*, in addition to *Fox, Hershfang* and *Shields*, *supra* p.10-11, *Ciresi v. Citicorp.*, 782 F. Supp. 819, 821 (S.D.N.Y. 1991), *aff'd mem.*, 956 F.2d 1161 (2d Cir. 1992); *Shields v. Washington Bancorporation*, No. 90-1101, 1992 WL 88004 at *6 (D.D.C. Apr. 7, 1992) (dismissing allegations that annual report "'falsely portrayed [the bank] as a sound, growing and responsible lender'"); *Driscoll v. Landmark Bank for Sav.*, 758 F. Supp. 48, 53 (D. Mass. 1991) ("If this complaint is sufficient, any plaintiff could file a suit against any New England bank that has experienced losses as a result of this period of recent economic turndown"), *amended complaint dismissed*, C.A. No. 90-11593-C, 1992 U.S. Dist. LEXIS 1718 (D. Mass.

(continued...)

stressed that without pleading such facts, a complaint contains only "fraud by hindsight" allegations which cannot satisfy Rule 9(b). In *Denny*, for example, a complaint alleged that a bank's foreign operations and loans, although "depicted with enthusiasm" in the company's 1973 through 1975 annual reports were, in fact "speculative and risky". The Second Circuit (Friendly, J.) focused upon the absence in the complaint of any "specification of what loans, at what times, and in what amounts were 'risky,'" and concluded that "[i]n the absence of such particulars, and given the myriad of foreign loans made by the Bank during the early 1970's, the simple use of the epithet 'risky' is no better than a 'mere conclusory allegation to the effect that defendant's conduct was fraudulent.'" 576 F.2d at 469. The court reached the same conclusion with regard to allega-

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4. (...continued)
Feb. 10, 1992); *Gollomp v. MNC Fin. Inc.*, 756 F. Supp. 228, 232 n.4 (D. Md. 1991) (fraud claim not supported by speculation that procedures were not conservative because of the later failure of loans); *Wilkes v. Heritage Bancorp., Inc.*, 767 F. Supp. 1166, 1173 (D. Mass. 1991) (complaint dismissed pursuant to Rule 9(b) because "plaintiffs' complaint does not give details of a single loan or transaction which was imprudent or made in violation of standard banking procedure"); *Dubowski v. Dominion Bankshares Corp.*, 763 F. Supp. 169, 172 (W.D. Va. 1991) (plaintiffs "have to do more than contrast quarterly and yearly statements"), *subsequent motion to dismiss denied*, No. 90-647-R (W.D. Va. Dec. 11, 1991) (certified for interlocutory appeal to 4th Cir.); *Haft v. Eastland Financial Corp.*, 755 F. Supp. 1123, 1128 (D.R.I. 1991) ("The 'how' of this complaint is so general that it . . . might apply to any financial institution in the Northeast"); *Vachon v. Baybanks, Inc.*, 780 F. Supp. 79, 82 (D. Mass. 1991) ("[t]he precipitous rise of loan loss reserves does not of itself indicate fraud"); *Zimmerman v. Shawmut*, No. 2:91 CV00258, 1991 WL 274342 at *6 (D. Conn. Dec. 13, 1991) ("plaintiff does no more than . . . compare [the recent loan loss] report with similar information from earlier reports, and conclude that the differences . . . must be attributable to fraud"); *Abrahamson v. Clark*, No. 88-1677, 1989 WL 259996, at *4 (D. Ariz. July 7, 1989) (dismissing conclusory claim that defendants "failed to adequately provide loan loss reserves"), *aff'd mem.*, 951 F.2d 358 (9th Cir. 1991).

tions that the bank fraudulently failed to disclose early enough the "fact" that other kinds of loans and investments were "speculative and risky,":

> Again, no specification of transactions is provided, and there is not even an indication of the date at which defendants knew the investments had become so unacceptably 'risky' that disclosure was required. The defendant is entitled to a narrower delineation of the charges than the plaintiff has provided.

Id. at 469-70. As Judge Friendly observed, while "greater clairvoyance" might have led to the realization in 1973 that petroleum prices might increase dramatically later that year, and in 1976 that New York City would come to the verge of bankruptcy late in that year, "failure to make such perceptions does not constitute fraud." *Id.* at 470.

The Third Circuit, prior to the *UJB* decision, was in agreement with such Circuits' approach. *See Christidis*, 717 F.2d at 100 (upon which, *inter alia*, *DiLeo* relied), discussed *infra*, at 20. Indeed, a different panel of the Third Circuit reached this same conclusion as *Christidis* on the same day as the decision in the instant case, adopting an approach contrary to *UJB* in a case involving a virtually identical complaint. *See Decker v. Landmark Sav. Ass'n*, No. 90-639, slip op. at 13-15 (W.D. Pa. June 12, 1991) (AII-23-25).

The practical effect of the Third Circuit's determination in *UJB* to sustain a fraud complaint based on the change in financial condition, is to hold that fraud by hindsight allegations *do* satisfy the pleading requirements of Rule 9(b). This is not the law in any of the circuits. The Seventh Circuit in *DiLeo* recently rejected precisely this type of fraud by hindsight pleading under Rule 9(b):

> The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. "Must be" is the critical phrase, for the complaint offers no information other than the differences

> between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting the difference is attributable to fraud.

901 F.2d at 627. The First, Second and Seventh Circuits have recognized that without the requirement that facts supporting the claim of wrongdoing be alleged, Rule 9(b) becomes a "paper tiger" that fails to fulfill its role of: requiring that a plaintiff investigate the facts and reasonably believe a fraud has occurred before filing suit; precluding unsubstantiated claims, the mere pendency of which injure the reputations of defendants; and preventing strike suits.[5] The Third Circuit itself recognized as much in *Christidis*, noting that "'[i]t has been the rule under both common-law and code pleading that allegations of fraud must be made with a great degree of particularity.'" 717 F.2d at 99 (citation omitted).

Some of these courts have relaxed somewhat the rigorous pleading standard under Rule 9(b) where the plaintiff has alleged that the facts lie solely within defendants' control. *See, e.g., DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1217 (2d Cir. 1987); *Wayne Investments v. Gulf Oil Corp.*, 739 F.2d 11, 13-14 (1st Cir.

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5. *See, e.g., Seville Indus. Mach. Corp. v. Southmost Mach. Corp.*, 742 F.2d 786, 791 (3d Cir. 1984) (important purposes served by Rule 9(b)'s particularity requirements include: (1) ensuring that plaintiff has investigated and reasonably believes a fraud has occurred; (2) providing adequate notice to defendants so that they can respond to this claim; and (3) protecting the reputation of defendants), *cert. denied*, 469 U.S. 1211 (1985); *New England Data Servs., Inc. v. Becker*, 829 F.2d 286, 289 (1st Cir. 1987) (requirements of Rule 9(b) serve: "(1) to place the defendants on notice and enable them to prepare meaningful responses; (2) to preclude the use of a groundless fraud claim as a pretext to discovering a wrong or as a 'strike suit'; and (3) to safeguard defendants from frivolous charges which might damage their reputations"); *see also O'Brien v. National Property Analysts Partners*, 936 F.2d 674, 676 (2d Cir. 1991).

1984). However, the relaxed standard applied by these circuits does not change the particularity requirement of Rule 9(b) or excuse plaintiffs from pleading specific facts in support of the fraud allegation; rather, it permits a plaintiff who cannot plead supporting facts upon personal knowledge to instead plead the very same supporting facts upon information and belief. *See*, *e.g.*, *Romani*, 929 F.2d at 878 ("[t]he requirement that supporting facts be pleaded applies even when the fraud relates to matters peculiarly within the knowledge of the opposing party"); *DiVittorio*, 822 F.2d at 1247 (where facts are peculiarly within defendants' knowledge or control, plaintiff's allegations must be "accompanied by a statement of the facts upon which the belief is based"); *see also In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1487 (N.D. Cal. 1992) ("where knowledge of certain matters pertaining to fraud is peculiarly within the defendant's knowledge, the particularity requirement . . . is relaxed . . . . Nonetheless this special rule does not read Rule 9(b) out of existence") (citations omitted). *See generally* 2A J. Moore, *Moore's Federal Practice* ¶ 9.03[1], at 9-27-9-28 (2d ed. 1991) ("Where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proffered").

The Third Circuit's decision in *UJB* relaxes this standard one giant—and qualitatively different—step further, stating:

> [E]ven under a more relaxed application of the rule, plaintiffs must accompany such an allegation with a statement of facts upon which their allegation is based. To avoid dismissal in these circumstances, a complaint must delineate at least the nature and scope of plaintiffs' effort to obtain, before filing the complaint, the information needed to plead with particularity.

964 F. 2d at 285 (citations omitted) (A-24). Thus, under the Third Circuit's newly-pronounced Rule 9(b) pleading standard, plaintiffs are not required to plead any facts giving rise to an inference of fraud. Instead, they merely are required to plead that the necessary information

supposedly exists but lies exclusively within defendants' control and that plaintiffs have been unable to discover any other facts to support their fraud claims (despite specified efforts to do so). This approach—which would let a plaintiff with *no* facts, just a "hunch," subject the defendants and the court to a full-scale litigation, at least through discovery and a summary judgment motion—is entirely contrary to the purposes and requirements of Rule 9(b) and the pleading standards in the First, Second and Seventh Circuits. The *UJB* standard guts the particularity requirement of Rule 9(b), leaving nothing but a complaint comprised of conclusory allegations and a statement by the plaintiff that it was unable to discover any facts supporting the assertion of fraudulent conduct. Such a standard renders Rule 9(b) meaningless in those situations in which the plaintiff has no facts showing that prior statements were false and is relying solely upon the change in financial condition between two different time periods to raise an inference of fraud in the earlier statements. Such standard, in effect, permits a fraud claim to survive if it satisfies the *de minimus* notice pleading requirements of Rule 8 (applicable to non-fraud pleadings), even if it does not satisfy Rule 9(b) (which was specifically drafted to govern fraud pleadings). Ironically, if, notwithstanding the allegation of a misstatement, there really has been no misstatement and thus there are no facts to plead how the challenged statement was inaccurate, the plaintiff could survive a motion to dismiss under the *UJB* standard by alleging what facts it believes exist and must be in defendants' control.

Under the Rule 9(b) standard articulated by the *UJB* panel—and contrary to this Court's teaching in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 741, *reh'g denied*, 423 U.S. 884 (1975), that in the securities law context, courts must be wary of "the possibility that a plaintiff with a largely groundless claim" will be able to use the discovery process to gain "an *in terrorem* increment of the settlement value"—a plaintiff may now commence and prosecute a fraud claim first, and hope either to coerce a settlement or to find facts, after subjecting defendants to lengthy and costly discovery, justifying the fraud charges levelled against defendants. *Compare Shields v. Washington Bancorporation*, No. 90-1101, 1992 WL 88004, at *8

(D.D.C. Apr. 7, 1992) ("Plaintiffs simply cannot allege the practices of the bank and a subsequent loss to make out a claim of fraud") and *id.* at *9 ("[w]ere the court to hold that plaintiffs' claims met Rule 9(b)['s] standard, anyone who had lost money on an investment would be able to sue for fraud. The only allegation necessary would be an unexpected financial setback. . . . With this one allegation plus the appropriate window-dressing by a good attorney, a claim would be born that might potentially have a substantial settlement value. Rule 9(b) must require more than this").

The Third Circuit's approach amounts to "issu[ing] a license for a fishing expedition in uncharted waters" (*Wayne*, 739 F.2d at 14) and is antithetical to one of the fundamental premises of our system of jurisprudence: a plaintiff is required to have sufficient facts to state a claim *before* filing the complaint; a plaintiff cannot file a fraud complaint and then force defendants to undergo the costs and other burdens of litigation while plaintiff tries to learn whether there really are (or are not) any facts to support its mere suppositions of wrongdoing. *Denny v. Barber*, 73 F.R.D. 6, 10 (S.D.N.Y.), *aff'd*, 576 F.2d 465 (2d Cir. 1978) ("[c]omplaints should not be conceived merely as tokens, guaranteeing access to a world of discovery . . . . Neither plaintiff nor his counsel are entitled to roam through a defendant's files at the mere drop of a 'complaint'"); *McFarland v. Memorex*, 493 F. Supp. 631, 639 (N.D. Cal. 1980). Contrary to these decisions, which reject a pleading standard under which a plaintiff can "shoot first" and "ask questions later" (i.e., plead fraud and hope to find something to support the charge in discovery), the Third Circuit decision in *UJB* suggests that such is an acceptable approach. In doing so, the Third Circuit subjects defendants to hundreds of thousands of dollars of legal fees in discovery and additional expense in connection with motions for summary judgment after discovery, as well as disruption of business as a result of extraordinary burdens on employees and management while plaintiff takes discovery; and thus grants plaintiff precisely what this Court long ago recognized as the "*in terrorem* increment of the settlement value" of a case without underlying merit. *Blue Chip Stamps*, 421 U.S. at 741.

2. Confusion Among the District Courts

The pleading standard established by the Third Circuit further complicates the already inconsistent application of Rule 9(b) by sending a signal to the lower courts that pleading fraud by supposition is acceptable as long as plaintiff has alleged that the facts needed to allege fraud lie solely within the defendant's control and further alleges the efforts plaintiff has made (without success) to find such supposed facts that would support its fraud claim. In light of the far-reaching implications of the Third Circuit's evisceration of Rule 9(b) in this context, and the already confused and inconsistent decisions of the district courts in applying Rule 9(b), it is essential for this Court to intervene.

Even prior to the *UJB* decision, district courts in and out of the Third Circuit have been utterly inconsistent, and often directly at odds with each other, with respect to the application of Rule 9(b). The same lawyers can (and do) file the same complaint against the same kinds of defendants; and depending upon which court—or even which judge within a court—hears the case, the results will be diametrically opposed. Some district courts require that facts be pled indicating how the alleged wrongful conduct was fraudulent, while other courts uphold complaints which simply (1) quote verbatim from the alleged misrepresentation, (2) provide the context in which the representations were made, and (3) identify the various defendants involved in the alleged fraud. *Compare Fox v. Equimark Corp.*, 782 F. Supp. 295, 300 (W.D. Pa. 1991) (plaintiff must allege more than the descriptions of the situation before and after the financial reverses and allege that difference must be due to fraud; rather, plaintiff must allege facts suggesting that the difference was attributable to fraud); *Heller v. NCNB Corp.*, 768 F. Supp. 167, 169 (W.D.N.C. 1991) ("complaint basically recites a series of financial reports, press releases and other information available to the public and then alleges that these were all false and misleading. . . . The complaint falls far short of providing an adequate factual basis for an inference of fraud and scienter"); *Wilkes v. Heritage Bancorp, Inc.*, 767 F. Supp. 1166, 1174-75 (D. Mass. 1991) ("must be" theory of fraud pleading not acceptable; court requires that plaintiff allege

factual details with respect to fraudulent conduct in particular loans, accounting practices or bank procedures); and *Mancini v. Prudential-Bache Fogelman Harbour Town Properties, L.P.*, No. 90-C-5213, 1991 WL 171966 at *6 (N.D. Ill. Sept. 3, 1991) ("[w]hile the projections [of operating revenues] are clearly different from the tale that was being told in [a later report], these differences alone do not bespeak fraud absent some facts suggesting that the differences are attributable to fraud") (citation omitted); *with In re Midlantic Corp. Shareholder Litig.*, 758 F. Supp. 226 (D.N.J. 1990) (complaint need not contain facts alleging why wrongful statements are fraudulent; complaint withstands Rule 9(b) challenge where pleadings contain quotes from alleged misrepresentation, and allege when these statements were made and who made them); *Nicholas v. Poughkeepsie Sav. Bank/FSB*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,606, at 97,836 (S.D.N.Y. Sept. 26, 1990) (same). (See also *supra*, pp.10-11). As a result, similar complaints filed in different district courts even within the same Circuit are receiving disparate treatment based upon a federal rule which should be applied uniformly.

The Third Circuit's decision in *UJB* will exacerbate the confusion among the district courts. District courts in the Third Circuit must choose between applying the *Landmark* or *UJB* decision--issued the same day, but taking opposite approaches—and district courts from other circuits may decide to adopt *UJB*'s unsound reasoning where their own Circuit has not spoken on the issue. The Third Circuit's position that a complaint claiming securities fraud under the federal law need not allege facts supporting the claim that a statement was false, but may be based solely upon a statement that plaintiffs have not yet uncovered the necessary facts, combined with an explanation of the efforts undertaken to uncover such facts, is unsound. This Court should reject that position and provide the lower courts with the uniform pleading standard which is sorely lacking.

B. Intra-Circuit Conflict In Applying Rule 9(b)

The pleading standard set forth by the Third Circuit in *UJB* also is inconsistent with the Third Circuit's opinions in *Christidis* and *Decker v. Landmark Sav. Ass'n*, No. 91-

3776 (3d Cir. May 20, 1992), a case, ironically, decided on the same day as *UJB*. In *Christidis*, 717 F.2d at 99, the Third Circuit affirmed dismissal of a complaint setting forth allegations (as here) relating to inadequate loan loss reserves, because Rule 9(b) requires "that the complaint state with particularity the circumstances constituting the fraud," and a plaintiff *must* show "how" a defendant's conduct was fraudulent in order to satisfy the particularity requirement. The court's requirement in this regard was the same as that which had been (or thereafter was) adopted by other circuits. *See*, *e.g.*, *Romani*, 929 F.2d at 878; *DiLeo*, 901 F.2d at 627 (citing *Christidis*); *Denny*, 576 F.2d at 470.

The Third Circuit in *Landmark* issued an order affirming the District Court's dismissal of the complaint with prejudice, expressly "for the reasons set forth in two opinions of Magistrate Judge Ila Jeanne Sensenich which was adopted by the district court." (AII-6) As in *UJB*, the complaint dismissed in *Landmark* alleged that the defendants had violated Sections 10(b) and 20(a) of the Exchange Act by making false and misleading statements concerning the bank's loan loss reserves, earnings and income, lending practices and internal management and credit controls. Unlike the *UJB* panel, the Third Circuit in *Landmark* affirmed the lower court's dismissal, acknowledging the critical requirement under Rule 9(b) set forth both in *Christidis* and by other circuits: plaintiff must allege "how" the statement was fraudulent or why defendants should have been on notice of the statement's falsity. The Third Circuit in *Landmark* reaffirmed the Rule 9(b) standard adopted by that circuit in both *Christidis* and *Craftmatic* that "[e]ven under a nonrestrictive application [of] . . . rule [9(b)], . . . [plaintiffs'] allegations must be accompanied by a statement of the facts upon which the allegations are based." *Landmark*, No. 90-639 slip op. at 11 (W.D. Pa. June 12, 1992) (AII-21).[6]

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6. *In re Craftmatic Securities Litig.*, 890 F.2d 628, recognized that "even under a non-restrictive application of [Rule 9(b)], pleaders must (continued...)

Remarkably, the pleadings dismissed in *Landmark* for lack of particularity contained defects identical to those identified by the District Court Judge, but excused by the Third Circuit, in *UJB*: the complete absence of any facts within the pleadings that demonstrate *how* defendants' conduct, when undertaken, was fraudulent.

> [Plaintiffs] do not identify *the way* in which Landmark's commercial business and residential real estate loan portfolios were risky. They do not identify *how* defendants exaggerated Landmark's earnings and net worth . . . . Plaintiffs allegations are broad and conclusory and lack factual support. As to plaintiffs' claim that Landmark failed to adequately reserve against loss, it is noted that in *Christidis* . . . the court held that the plaintiff's claim that defendants' financial statements understated the reserves which the trust should have accrued for bad debts [sic] did not sufficiently allege fraud with the specificity required by Rule 9(b) and was properly dismissed.

Landmark, slip op. at 13-14 (emphasis added) (AII-23-24).

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6. (...continued)
allege that the necessary information lies within defendants' control, and their allegations must be accompanied by a statements of the facts upon which the allegations are based." *Id.* at 645. The *Craftmatic* court interpreted the latter requirement to mean that plaintiffs who plead a fraud claim based upon information and belief instead of personal knowledge "must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants' control." *Id.* at 646. In other words, plaintiffs must plead facts demonstrating *why* the difference between "rosy" statements, for example, and later, less favorable results, is attributable to fraud. *DiLeo*, 901 F.2d at 627 (emphasis added). *Accord VT Investors v. R&D Funding Corp.*, 733 F. Supp. 823, 836-39 (D.N.J. 1990) (dismissing securities fraud and RICO claims pursuant to Rules 9(b) and 12(b)(6) because, even under a "relaxed pleadings standard," "plaintiffs have failed to point to any evidence that [the challenged] statements were false and misleading"; "the averment of fraud is mere suspicion").

The *UJB* opinion departs from previous and contemporaneous Third Circuit decisions in *Christidis*, *Craftmatic* and *Landmark*, as well as other Circuits' standards and Rule 9(b) itself, by disregarding the requirement that a plaintiff must plead facts to demonstrate that its claims are not baseless. Without the application of this requirement, the Third Circuit's approach in *UJB*, pays only lip-service to Rule 9(b)'s pleading requirements.[7]

The stark inconsistencies in the *UJB* and *Landmark* decisions, decided on the same day by two separate panels of the Third Circuit and reaching different conclusions regarding the allegations required to adequately plead fraud in federal securities law cases, should be considered by this Court in judging the merit of granting certiorari. This Court repeatedly has accepted certiorari when an intra-circuit conflict relates to a recurring and important issue or is accompanied, as here, by a widespread conflict among the circuits. *See*, *e.g.*, *Scarborough v. United States*, 431 U.S. 563, 567 n.4 (1977) (certiorari granted because of "split among the Circuits," one circuit noted as having an intra-circuit conflict); *Maggio v. Zeitz*, 333 U.S. 56, 59-60 (1948) (certiorari granted because of differing views within a circuit that was most frequently confronted with difficult bankruptcy issue); *Dickinson v. Petroleum Conversion Corp.*, 338 U.S. 507, 508 (1950) (certiorari granted "because of this intra-circuit conflict"); *John Hancock Mut. Life Ins. Co. v. Bartels*, 308 U.S. 180, 181 (1939) (certio-

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7. *See also*, as yet another example of the Third Circuit's inconsistency in interpreting Rule 9(b), *Seville Industrial Machinery Corp. v. Southmost Machinery Corp.*, 742 F.2d 786, 791 (3d Cir. 1984), *cert. denied*, 469 U.S. 1211 (1985), where the Third Circuit held that allegations of "date, place or time" are not required to plead fraud with particularity, so long as plaintiff "inject[s] precision and some measure of substantiation into their allegations of fraud," and which is irreconcilably in conflict with the First and Second Circuits' requirement that under Rule 9(b), fraud pleadings must specify the time, place, speaker and content of the alleged misrepresentation. *See DiVittorio v. Equidyne Extractive Indus., Inc.*, 822 F.2d 1242, 1247 (2d Cir. 1987); *Wayne Inv., Inc. v. Gulf Oil Corp.*, 739 F.2d 11, 13 (1st Cir. 1984).

rari granted because of intra-circuit conflict and the importance of the question). Given the *UJB* panel's denial of defendants' petition for rehearing, without this Court's intervention, the district courts in the Third Circuit will have no guidance as to whether it should follow *Landmark* or *UJB*, thus increasing the likelihood of numerous conflicting decisions.

C. The Third Circuit Decision Undercuts the Policies Underlying Rule 9(b)

The Third Circuit's newly-pronounced "relaxed" standard in effect equates Rule 8 and Rule 9(b), an equation that Congress, in adopting separate rules, and other Circuits, have declined to make. Other Courts of Appeals have recognized that, because of the serious implications to defendants of fraud charges and the resulting important purposes served by requiring that facts be pled in detail to support any such charges (see *supra*, pg. 25), Rule 9(b) imposes greater requirements than mere notice pleading permissible under Rule 8, applicable in actions which do not allege fraud. *See, e.g., Luce v. Edelstein*, 802 F.2d 49, 54 (2d Cir. 1986); *Hayduk v. Lanna*, 775 F.2d 441, 444 (1st Cir. 1985); *Friedlander v. Nims*, 755 F.2d 810, 813 n.3 (11th Cir. 1985).

Rule 9(b) serves a particularly important purpose because in the securities litigation context, the problem of strike suits and coercion of settlements is exacerbated by the high stakes involved and the potential for extensive, costly discovery regarding groundless claims. *See*, in addition to *Blue Chip*, *supra*, *Romani*, 924 F.2d at 878; *Konstantinakos v. FDIC*, 719 F. Supp. 35, 38 (D. Mass. 1989) ("[R]ule [9(b)] is especially important in securities fraud cases where the strike suit value of a complaint is high"). Absent some requirement that plaintiffs do more than quote the statements from an early annual report and then from a later, less favorable one, and allege in conclusory fashion that the earlier, more positive one reflects fraud, the securities laws become nothing more than either an insurance policy guaranteeing that the shareholder is placed in a "no lose" situation, *DiLeo*, 901 F.2d at 627, or an *in terrorem* weapon to coerce settlements. As this Court recognized in *Blue Chip Stamps v. Manor Drug*

Stores, 421 U.S. 723, 741 (1975), enforcing threshold pleading requirements in the context of securities litigation operates to diminish the possibility:

> that a plaintiff with a largely groundless claim [will be able] to simply take up the time of a number of other people [by extensive discovery], with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence. . . .

The First Circuit, following this rationale, has emphasized that courts should be "especially rigorous in demanding . . . factual support in the securities context to minimize the chance 'that a plaintiff with a largely groundless claim will bring a suit and conduct extensive discovery in the hopes of obtaining an increased settlement, rather than in the hopes that the process will reveal relevant evidence.'" *Romani*, 929 F.2d at 878 (citation omitted). Unlike the First Circuit, the Third Circuit has failed to heed the words of this Court. The Third Circuit would now sanction such pleadings even where plaintiff has no facts other than a comparison of the two disclosures. As recently noted by one commentor, the Third Circuit's decision in *UJB* opens the floodgates for the pursuit of fraud claims without any facts indicating that a fraud has occurred. Brodsky, *Suits Resulting From The Banking Crisis*, N.Y.L.J. July 30, 1992, at 3.

In advocating its "wait until after discovery" approach to delaying the dismissal of unsubstantiated fraud claims, the Third Circuit has eliminated an effective tool in combating what this Court has recognized to be the "widespread abuse of discovery that has become a prime cause of delay and expense in civil litigation." *Herbert v. Lando*, 441 U.S. 153, 179 (1979) (Powell, J., concurring); *see also* Kastenmeier & Remington, *Court Reform and Access to Justice: A Legislative Perspective*, 16 Harv. J. on Legis. 301, 303 (1979) ("the twin demons of cost and delay are asphyxiating our courts, both state and federal [with] pernicious effects on the quality of justice").

It is untenable that this Court would let stand a decision that supports the "sue first, find claims later" view

that has contributed to "a system so indulgent of dubious claims, defenses, and behavior that it [has fallen] prey to adversarial ethics, crowded dockets, rising litigation costs, abusive discovery and holdup litigation." Louis, *Intercepting And Discouraging Doubtful Litigation: A Golden Anniversary View Of Pleading, Summary Judgment, And Rule 11 Sanctions Under The Federal Rules Of Civil Procedure*, 67 N.C. L. Rev. 1023, 1028-1029 (1988).

In permitting factually unsupported charges of fraud to rise to the level of a federal securities law claim, the Third Circuit not only ignores the consequences its determination may have upon the court system, but also disregards the important task of safeguarding the reputation of defendants whose only protection against conclusory charges of fraud contained in publicly-filed pleadings is that afforded by judicial enforcement of Rule 9(b). As the Second Circuit in *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111 (2d Cir. 1982) (*citing Segal v. Gordon*, 467 F.2d 602, 607 (2d Cir. 1972)), stated:

> It is a serious matter to charge a person with fraud and hence no one is permitted to so do unless he is in a position and is willing to put himself on record as to what the alleged fraud consists of specifically.

Id. at 115. The need to safeguard a defendant's reputation under Rule 9(b) is unquestionable in the current economic environment. Rarely, if ever, have federal courts been so inundated with a continuous stream of virtually identical lawsuits containing allegations so general that they could be filed against any financial institution suffering in our declining economy. *See Shields v. Amoskeag Bank Shares Inc.*, 766 F. Supp. 32, 38 (D.N.H. 1991). The Third Circuit would permit such pleadings-by-photostat to stand no matter what the cost to defendants' reputations or to the court system.

A more subtle danger with the Third Circuit's approach is its implicit impingement on another of this Court's decisions, *Santa Fe Industries v. Green*, 430 U.S. 462 (1977). *Santa Fe* held that claims of mismanagement or breach of fiduciary duty do not rise to the level of violations of Section 10(b). This Court held that Congress, in

enacting Section 10(b), "'did not seek to regulate transactions which constitute no more than internal corporate mismanagement,'" *id.* at 479 (*citing Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971)), and recognized the "danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5." *Id.* (citation omitted). By permitting a Section 10(b) claim to stand without requiring the plaintiffs to set forth facts detailing (in accordance with Rule 9(b)) their fraud by hindsight allegations, the Third Circuit has condoned the filing of federal securities law claims based upon plaintiffs affixing conclusory characterizations of fraud to conduct that would, at most, amount to possible mismanagement. As the court in *In re The One Bancorp Securities Litigation*, 135 F.R.D. 15 (D. Me. 1991), recognized when dismissing claims which contained only conclusory allegations that a bank's provision for loan losses was fraudulent, "plaintiffs must allege more than internal corporate mismanagement to satisfy [the pleading requirements of] Rule 9(b)." *Id.* at 14.[8]

The Third Circuit in *UJB* recognizes and adopts the *Santa Fe* position with respect to its analysis of plaintiffs' allegations of inadequate loan loss reserves or improper or imprudent lending and credit monitoring practices, under Rule 12(b)(6) (*see* 964 F.2d at 281) (A-17); yet it inconsistently ignores *Santa Fe* when undertaking its Rule 9(b) analysis. For example, as the district court here correctly recognized, plaintiffs' allegations that UJB's earnings were overstated as a result of inadequate loan loss reserves without pleading facts indicating how, or in what manner, the challenged statements were fraudulent, reflects no more than a disagreement with the company's judgment as to the appropriate level of loan loss reserves or a claim of mismanagement which does not deserve scrutiny by the

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8. Ironically, the *Landmark* court, in dismissing under Rule 12(b)(6) allegations virtual identical to those at issue in *UJB*, found that "[w]hile these [fraud by hindsight] claims might support a claim of mismanagement by defendants, *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), recognized that mismanagement is not a basis for a federal claim." *Landmark*, slip op. at 13 (AII-23).

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federal courts.[9] The Third Circuit's decision, in contrast, is inconsistent with the holding and rationale of *Santa Fe*. By excusing a plaintiff from pleading facts to support the conclusory characterization of conduct as fraudulent, the Third Circuit departs not only from Rule 9(b) but even Rule 12(b)(6), pursuant to which the Courts examine whether the *facts* pleaded, not the plaintiff's self-serving conclusions or characterizations contained in the complaint, are sufficient to state a claim. *See generally* 5 C. Wright & A. Miller, *Federal Practice and Procedure* § 1357, at 311-21 (2d ed. 1990) (pleadings of conclusions or characterizations of fact, without pleading of facts themselves, should *not* be accepted by the Court); 2A J. Moore & J. Lucas, *Moore's Federal Practice* ¶ 12.07 [2.-5], at 12-63-64 (2d ed. 1991).

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9. As the Third Circuit recognized in *UJB*, the setting of a loan loss reserve is an economic judgment which can only be validated at some later date. 964 F.2d at 281 (A-17). Indeed, reserves are simply an estimate or prediction of future losses. *See Christidis v. First Pa. Mortgage Trust*, 717 F.2d 96, 100 (3d Cir. 1983) ("reserves were estimates or predictions of the likely collection or liquidation experience"); *TCF Banking & Sav. F.A. v. Arthur Young & Co.*, 706 F. Supp. 1408, 1412 (D. Minn. 1988) (establishment of loan loss reserve "involves economic forecasting, not the reporting of known facts"). The governing FASB Statement No. 5 of Financial Accounting Standards specifically requires that the loss be both *probable and reasonably estimable* before it is accrued. *Financial Accounting Standards Boards, Accounting Standards - Current Text - General Standard, Contingencies as of 1990* at ¶ C59.105 (losses from uncollectible receivables (such as principal and interest on loans) shall be accrued when both conditions (probable and reasonably estimable) are met).

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II. THE THIRD CIRCUIT'S STATEMENT THAT COMMENTING ON A MATTER MAKES SUCH MATTER *PER SE* MATERIAL CONFLICTS WITH THE DECISION OF THIS COURT IN *BASIC*

Having announced a new and incorrect standard pursuant to which plaintiffs may allege fraud without pleading facts as to how and why the challenged statement was false, the Third Circuit then compounded its error as to the pleading standard by ignoring—indeed, taking the approach expressly rejected in—this Court's prior decision governing the materiality of any such challenged statement. As a result, certiorari should be granted pursuant to Sup. Ct. R. 10.1.(c). The Third Circuit's statement in *UJB* that "[b]y addressing the quality of a particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder, and thus is bound to speak truthfully" (964 F.2d at 282 (A-18)), flatly ignores *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). In *Basic*, this Court considered and rejected the rule proposed by the Sixth Circuit that "information concerning ongoing acquisition discussions becomes material by virtue of the statement denying [its] existence." 485 U.S. at 237. The Third Circuit—which *sua sponte* raised the point, without the benefit of any briefing or argument, much less discussion of *Basic's* holding—thus has attempted to revive the very same reasoning rejected by this Court.

In *Basic*, this Court held that a plaintiff must "show that the statements were *misleading* as to a *material* fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant." 485 U.S. at 238 (emphasis in original). As this Court further expressly recognized, "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." *Id.* at 240. The Third Circuit, however, has incorrectly stated that such an analysis is not necessary once a statement has been made and disseminated to the public.

CONCLUSION

The total effect of the *UJB* decision is that: (i) plaintiffs can satisfy the pleading requirement under Rule 9(b) simply by alleging that a statement was false, without possessing or pleading the facts showing how or why the statement was false; and (ii) by pleading the mere fact that the statement was made, plaintiff may establish materiality, without more, in direct contravention of *Basic*. Thus, for example, under the Third Circuit's decision here, plaintiffs' claim based upon UJB's statement that its lending policies were prudent could withstand a motion to dismiss under Rule 9(b) without plaintiff pleading any facts showing how or why UJB's lending policies were not prudent; and such statements, simply by virtue of the fact that they were made would be regarded as material.

The danger of leaving undisturbed the Third Circuit's erroneous decision on these issues goes far beyond the boundaries of this particular case, because district courts within the Third Circuit and other courts without the circuit well might rely on such precedent to effectively abolish the pleading requirement under Rule 9(b) and to adopt a reading of *Basic* inconsistent with this Court's holding and intent. This Court has the ability to prevent the flood of litigation that will ensue should the Third Circuit's newly-pronounced pleading standard under Rule 9(b) and misstatement of this Court's holding in *Basic* be left undisturbed.

Accordingly, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Filed: May 20, 1992

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-5153

IRWIN SHAPIRO, on behalf of himself
and all others similarly situated

v.

UJB FINANCIAL CORP.;
T. JOSEPH SEMROD; and
JOHN R. HAGGERTY

Irwin Shapiro, Robert Bassman,
Jerome Katz, Norman Salsitz,
Jean Lee, Executrix of the
Estate of Calvin Lee, and
Chappaqua Family Trust

Appellants

On Appeal from the United States District Court
for the District of New Jersey
(D.C. Civil Action No. 90-01569)

Argued September 17, 1991
Before: BECKER and SCIRICA, *Circuit Judges*
and VanARTSDALEN*, *District Judge*

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*The Honorable Donald W. VanArtsdalen, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

(Filed: May 20, 1992)

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OPINION OF THE COURT

SCIRICA, *Circuit Judge*.

This case is one of a number of federal securities actions against financially troubled banking institutions. After a sharp downturn in the financial condition of defendant UJB Financial Corporation, its shareholders filed a complaint alleging violations of §§ 11, 12(2), and 15 of the Securities Act of 1933 and §§ 10(b), 14(a) and 20(a) of the Securities Exchange Act of 1934, and various pendant state law claims. These claims are predicated on allegedly false and misleading statements made by UJB and other defendants regarding the company's loan loss reserves, earnings and income, lending practices, and internal management and credit controls.

The district court dismissed most of plaintiffs' federal claims for failure to state a claim upon which relief could be granted and for failure to plead with particularity. Fed. R. Civ. P. 12(b)(6), 9(b). The court also found that plaintiffs failed to state a common law claim for negligent misrepresentation. We will affirm in part and reverse in part.

I. BACKGROUND

Defendant UJB Financial Corporation, a New Jersey based bank holding company that offers a wide range of financial services, consists of 12 member banks and 11 non-bank subsidiaries.[1] Its common and Series B preferred stock are traded on the New York Stock Exchange. When plaintiffs' complaint was filed, UJB had more than $11

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1. This factual narrative is drawn from the complaint.

billion in assets, $7 billion in outstanding loans, and $8 billion in total consolidated deposits. The remaining defendants are individuals who were UJB officers[2] and directors[3] during the relevant time period, February 1, 1988 to July 18, 1990.

From 1987 to 1989, UJB saw substantial growth in assets, earnings, net income, and net worth. Total loans increased from $6.5 billion to $8.3 billion, total assets from $10.1 billion to $12.1 billion, and net income from $102 million to $118 million. The company's periodic announcements, made in quarterly and annual reports, press releases, and governmental filings, often contained more than just routine recitations of financial figures. The announcements repeatedly referred to UJB's "prudent," "cautious," and "conservative" lending policy, its "strict" credit administration practices, its "minimal" foreign loan exposure, and its "basic" approach to loan management. There were also frequent references to UJB's adherence to "sound" and "time-tested" banking practices, the "high" quality of its loan portfolio, and its "high safety margin." UJB also represented that its loan loss reserves were "strong" or "very Strong," and had been and would continue to be "maintained at a level determined adequate." The bank further attributed its overall success to its "strategy" of limiting its business dealings to the New Jersey region and avoiding concentration on a few large projects.

The first sign of a downturn appeared in March, 1990, when UJB filed a 10-K Report with the Securities and Exchange Commission. The accompanying 1989 Annual Report stated that the provision for loan losses had been increased as a "prudent" measure, and asserted that the loan loss reserves, which had recently been augmented by

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2. T. Joseph Semrod (President and Chief Executive Officer of UJB and Chairman of its Board of Directors); Clifford H. Coyman (President, Chief Executive Officer, and Director); and John R. Haggerty (Chief Executive Officer and Senior Vice President).

3. Robert L. Boyle, Elinor J. Ferdon, Walter L. Dealtry , Fred G. Harvey, Francis J. Mertz, Henry S. Patterson, II, James A. Skidmore, Jr., and Joseph M. Tabak. All served on UJB's Audit Committee during 1989.

13.1%, were "at a level determined adequate." The same Annual Report contained an interview with UJB's President and Chief Executive Officer, Joseph Semrod, who attributed the increase in bad loans to the cyclical nature of the banking business, a slow economy, and problems in residential real estate construction and development. He noted, however, that this part of UJB's loan portfolio was "well secured," and that UJB continued to have "good loan to value ratios." He projected "continued solid growth," but conceded that UJB was "budgeting a smaller real estate portfolio."

UJB's troubles escalated in March and April of 1990 when three financial evaluation services—Moody's Investors Service, Fitch Investors Service, and Standard & Poors—downgraded their ratings of UJB debt, stock, and commercial paper, as well as their ratings of deposits belonging to UJB's principal bank subsidiary, United Jersey Bank. These analysts expected UJB's credit quality to deteriorate, particularly with regard to real estate, construction, and land development loans.

On April 18, 1990, UJB issued a press release announcing a dramatic decline in net income and an equally striking increase in its loan loss reserves and non-performing assets. Semrod nevertheless reassured the public that the "long term is what counts," and that UJB was both "positioned for the '90s and beyond" and "focused on maximum sustainable, long-range earning growth and maximum long-term return." On July 18, 1990, UJB issued another press release announcing that the company's loan loss provision was four times what it had been the year before, and that earnings and income had dropped again. The price of UJB's common stock, which had been as high as $27 per share in the prior three years, plummeted to approximately $10 per share.

In reaction to these developments, plaintiff shareholders filed this class action. They attribute their economic losses to "a campaign [by defendants] to depict the illusion of UJB as a growing, profitable and vital lending institution with conservative lending practices, and a system of internal controls proper to ensure adequate collateralization and prompt recognition and accounting for problem loans." According to plaintiffs, defendants' public announcements in

the years 1988-1990 portrayed UJB "in a falsely optimistic manner" by stating that the loan loss reserves were adequate, loan review procedures and policies were stringently and continuously applied, lending opportunities were balanced appropriately against risks, and financial results were positive.

The claims of the plaintiff class[4] are grouped into three separate Counts. Count I alleges that defendants misrepresented and failed to disclose material information in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1988), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1991). Count I also alleges that the individual defendants are liable as "controlling persons" under § 20(a) of the Exchange Act, 15 U.S.C. § 78t (1988), for UJB's alleged § 10(b) violations. Count II avers that representations made in certain UJB registration statements and prospectuses violated §§ 11 and 12(2) of the Securities Act of 1933. 15 U.S.C. §§ 77k(a), 77l(2) (1988). In addition, it alleges that the individual defendants are liable to certain members of the plaintiff class as "controlling persons" under § 15 of the Securities Act, 15 U.S.C. § 77o (1988). Finally, Count III charges that defendants negligently misrepresented and omitted material information in violation of their common law duty of care.[5] The complaint sets forth many detailed

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4. The plaintiff class consists of all persons who purchased UJB's publicly traded securities between February 1, 1988 and July 18, 1990.

5. The district court did not dismiss Count IV, in which individual plaintiff Chappaqua Family Trust asserted a claim under § 14(a) of the Securities and Exchange Act, 15 U.S.C. § 78n (1988). The Trust voluntarily withdrew this claim with prejudice during the pendency of this appeal. At oral argument, however, defendants suggested that the withdrawal of Count IV was improper because plaintiffs failed to give notice and opportunity to be heard to members of the plaintiff class. This argument is unavailing because Count IV was asserted by the Chappaqua Family Trust, not the class representatives. See Complaint ¶ 79. Therefore, we need not and do not address whether a class representative may withdraw a § 14(a) claim without giving the class notice and opportunity to be heard.

(continued...)

factual allegations in support of these claims, but paragraph 52 summarizes them all.[6]

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5. (...continued)

The district court dismissed Count V, which alleged a breach of fiduciary duties under New Jersey corporate law. This dismissal has not been appealed.

6. Paragraph 52 provides:

"During the Class Period, the defendants, individually and in concert, directly and indirectly, engaged and participated in or aided and abetted a continuous course of conduct and conspiracy to conceal adverse material information regarding the finances, financial condition and future prospects of UJB as specified herein. Defendants employed devices, schemes, and artifices to defraud and engaged in acts, practices, and a course of conduct as hereinafter alleged in an effort to maintain artificially high market prices for the securities of UJB. This included the formulation, making of and/or participation in the making of untrue statements of material facts and omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, and engaging in acts, practices, and courses of business which operated as a fraud and deceit upon plaintiffs, and the Class. These included, among other things, the following:

(a) that the earnings, assets, and net worth of UJB were improperly and materially overstated and inflated throughout the Class Period due to grossly inadequate provisions for loan loss reserves;

(b) that the defendants caused UJB to continually understate its non-performing loans and failed to provide adequate loan loss reserves for problem loans promptly and properly, and instead granted extensions, further credits, and other beneficial loans to its problem loan customers, in order to postpone improperly the recognition of said problems in the publicly disseminated financial statements of UJB;

(c) that UJB's total loan loss reserves, particularly reserves for construction loans, were not maintained at an adequate level in light of the economic conditions prevailing in certain areas of loan concentration and the concomitant high risk of non-collectibility of a large portion of UJB's commercial real estate and other loans;

(continued...)

6. (...continued)

(d) that, many of UJB's larger problem loans, including but not limited to construction loans, and other loans in the Company's commercial loan portfolios, were not adequately collateralized or secure, contrary to defendants [sic] representations that:

- 'our portfolio is well secured' and 'we continue to have good loan to value ratio' . . . ;
- the Company's 'construction and real estate related loans . . . are . . . well collateralized . . . ;'
- that UJB had 'high asset quality' . . .

(e) that UJB's credit review and authorization standards and policies and system of internal controls to assure adequate collateralization and prompt recognition and accounting for problem loans were not conservative, were not functioning adequately or were being disregarded, not followed or circumvented by senior officers of the Company in order to maintain artificially high reported loan and earnings growth, contrary to defendants' representations that:

- that UJB adheres to 'conservative policies . . . in quickly recognizing non performing assets' . . .;
- that UJB had, '[I]n our effort to minimize our risk . . . followed conservative underwriting standards' with respect to construction and development loans . . .;
- that UJB's 'corporate policy toward residential, industrial and commercial construction loans' were 'conservative, cautious and therefore, profitable' . . .;
- that UJB's loan quality was strong because the Company was 'paying attention to the basics of loan administration' . . .;
- that 'quality' was a 'guiding principle in [UJB's] loan portfolio' . . .;
- that UJB had a 'lending philosophy which emphasizes the prompt identification and follow up of problem loans' and a 'conservative approach to problem loan recognition' . . .;
- that UJB 'emphasize[d] the basics of proper loan origination

(continued...)

Defendants filed a motion to dismiss, which the district

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6. (...continued)

procedures and good credit administration' and 'carefully monitor[s] our portfolio and . . . maintain[s] a strong allowance for loan losses . . .' . . .;

- that UJB had been 'prudent' in construction lending . . . and;

- that UJB had a 'prudent lending philosophy' . . .

(f) that, UJB's lending practices and controls were not sufficiently centralized, were unmanageable, and UJB's commercial lending officers had engaged in high risk and speculative loan transactions, which were not being adequately supervised, controlled, or directed by higher management, contrary to defendants' representations as set forth herein;

(g) that UJB would be required to add substantial additional amounts to its loan loss reserves as a result of its lending practices, contrary to defendants representations that:

- that UJB had a 'low level of non performing loans,' a 'very strong allowance for loan losses' and 'solid loan loss reserve' . . .;

- that UJB's loan loss reserves were 'maintained at a level determined adequate to provide for potential losses on loans' . . . .

(h) that by announcing increases in non-performance loans or increases in reserves at various times during the Class Period (including but not limited to announcements or statements dated October 18, 1989, January 16, 1990, March 15, and April 15, 1990), defendants failed to disclose the full truth regarding UJB's problem loans and lack of controls and, indeed, gave the materially false and misleading impression that UJB had taken all steps that were necessary or appropriate in connection with UJB's problem loans; and

(i) that given the existence of these undisclosed facts concerning UJB, its business, financial condition and performance, finances and future prospects, any investment in UJB involved an extraordinary high degree of risk."

Complaint ¶ 52.

court granted in part and denied in part. The district court dismissed with prejudice all claims in Counts I and II "to the extent that they rely on ¶¶ 52(a), (b), (c), (f), and (g) of the amended complaint, and to the extent that they rely upon allegations of mismanagement in ¶¶ 52(d) and (e)." It also dismissed with prejudice the § 15 claim in Count II and the negligent misrepresentation claim in Count III. The § 11 and § 12(2) claims of Count II were dismissed for failure to state a claim upon which relief could be granted, but the district court gave plaintiffs 30 days to amend their complaint to remedy defects identified in its opinion. Finally, the district court specifically upheld the § 20(a) "controlling person" claim in Count I.

The district court found that the remaining allegations in Counts I and II based on subparagraphs 52(d), (e), (h) and (i) did not satisfy Federal Rule of Civil Procedure 9(b), which requires that fraud be pleaded with particularity. However, the court did not formally dismiss these allegations. Instead, it granted plaintiffs 30 days to amend the complaint. The court also ordered class representative Jerome Katz to post $50,000 as security in connection with the § 11 and § 12(2) claims. Following this order, plaintiffs formally announced that they would neither amend their complaint nor provide security, and instead filed a timely appeal from the district court's order. Defendants moved to dismiss the appeal.

II. JURISDICTION

Defendants asset that there is no final appealable order because several claims were not formally dismissed by the district court.[7] According to defendants, the following two groups of claims rendered the district court's order non-final: (1) all claims asserted in Counts I and II, to the extent they rely upon allegations of fraud in subparagraphs 52(d), (e), (h), and (i) of the complaint, and (2) the § 20(a) claim asserted in Count I. We will address these contentions in turn.

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7. The courts of appeals have jurisdiction over appeals "from all final decisions of the district courts of the United States," 28 U.S.C. § 1291 (1988).

A. § *10(b), § 11, and § 12(2) Claims*

The major obstacle to appellate jurisdiction involves the allegations that did not satisfy Rule 9(b). Ordinarily, such claims are dismissed with leave to amend. Here, however, the district court did not dismiss but rather granted leave to amend, stating that "to the extent that plaintiffs do not submit these amendments within thirty days, the court will entertain a renewed motion to dismiss." No amendment was submitted, and the district court never formally dismissed the claims. Plaintiffs maintain that they cured any finality problems by announcing they would stand on their complaint and would not amend.

Guided by the Supreme Court's directive that we employ a "practical rather than a technical construction" of § 1291's finality requirement, *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 546 (1949), we have held that a plaintiff can convert a dismissal with leave to amend into a final order by electing to stand upon the original complaint. *See, e.g., Borelli v. City of Reading*, 532 F.2d 950, 951-52 (3d Cir. 1976) ("Only if the plaintiff . . . declares his intention to stand on his complaint . . . the order becomes(s) final and appealable"). Plaintiffs here formally stood on their complaint, but defendants contend that this was not enough. They maintain that we lack jurisdiction because plaintiffs failed to obtain an explicit dismissal with prejudice. We do not agree.

The district court stated it would entertain a renewed motion to dismiss if plaintiffs did not amend, but gave no indication that it would reconsider its earlier rulings. It seems clear that the district court planned to dismiss with prejudice any claims not amended. Requiring plaintiffs to return to the district court now would be a wasteful elevation of form over substance. *See Schrob v. Catterson*, 948 F.2d 1402, 1407 (3d Cir. 1991); *but see Hatch v. Lane*, 854 F.2d 981, 982 (7th Cir. 1988). Thus, once the amendment period expired, the district court's order had the effect of dismissing the improperly pleaded claims with prejudice.

Our analysis is supported by *Bankers Trust Co. v. Mallis*, 435 U.S. 381 (1978), where the United States Supreme Court addressed the effect of the parties' failure to comply with Federal Rule of Civil Procedure 58 on appel-

late jurisdiction. Rule 58 provides that no "decision by the [district] court that . . . all relief shall be denied" is effective until the clerk of the district court prepares, signs, and enters a separate "judgment" that is both "set forth on a separate document" and noted on the docket sheet. Fed. R. Civ. P. 58. The Court held that the parties were free to waive these requirements because the timing of the appeal was not in doubt. *Id.* at 384. The Court noted that:

> Certainty as to timeliness . . . is not advanced by holding that appellate jurisdiction does not exist absent a separate judgment. If, by error, a separate judgment is not filed before a party appeals, nothing but delay would flow from requiring the court of appeals to dismiss the appeal. Upon dismissal, the district court would simply file and enter the separate judgment, from which a timely appeal would then be taken. Wheels would spin for no practical purpose.

Id. at 385.

We believe that no practical purpose would be served if we were to dismiss this appeal. Defendants do not question the timeliness of the appeal. *See Jung v. K. & D. Mining Co.*, 356 U.S. 325 (1958). Nor is there any doubt that the district court would, on remand, simply dismiss the defective claims left unamended, not revise its earlier reasoning. *Id.* at 337. Therefore, we will treat the district court's order as a final dismissal.

B. § *20(a) Claim*

Plaintiffs contend that § 20(a) does not create a separate cause of action, but rather depends entirely on the viability of § 10(b) claims. They maintain that "controlling person" liability can exist only if primary liability has been established as to another defendant. Therefore, once all predicate § 10(b) claims are dismissed, there are no allegations upon which § 20(a) liability can be based. We agree.

Section 20(a) imposes joint and several liability on any person who "controls a person liable under any provision

of" the Securities Exchange Act of 1934.[8] The text of the statute plainly requires the plaintiff to prove not only that one person controlled another person, but also that the "controlled person" is liable under the Act. If no controlled person is liable, there can be no controlling person liability. *Wool v. Tandem Computers Inc.*, 818 F.2d 1433, 1440-1 n.8 (9th Cir. 1987). Here the dismissal of the § 10(b) claims against UJB made it impossible to hold the individual defendants liable under § 20(a).

There being no other extant claims, we are satisfied that the district court's order was final, and that we have jurisdiction over this appeal.

III. DISCUSSION

Plaintiffs make four principal arguments on appeal. First, they maintain that they have alleged fraud under § 10(b) with sufficient particularity, rather than mismanagement. Second, they contend that the same allegations state actionable § 11 and § 12(2) claims and are grounded in negligence rather than fraud. Third, they argue that they have properly alleged negligent misrepresentation under New Jersey law. Finally, they challenge the district court's order requiring class representative Katz to post security.

Our review of the district court's dismissal of the complaint for failure to state a claim upon which relief can be granted is plenary. We must accept as true the factual allegations contained in the complaint, and may affirm the dismissal only if it appears certain that plaintiffs can prove no set of facts that would entitle them to relief. *Ransom v.*

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8. This section provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1988).

Mariazzo, 848 F.2d 398, 401 (3d Cir. 1988). We also have plenary review of the district court's interpretation of the federal securities laws, *Dent v. Cunningham*, 786 F.2d 173, 174 (3d Cir. 1986), and its determination of New Jersey law. *Salve Regina College v. Russell*, ___ U.S. ___, 111 S. Ct. 1217 (1991). Finally, we review the district court's requirement of security for abuse of discretion. 15 U.S.C. § 77k(e) (1988).

A. *Section 10(b)*

Under the authority provided by § 10(b) of the Exchange Act of 1934,[9] the Securities and Exchange Commission promulgated Rule 10b-5,[10] which make it unlaw-

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9. Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful for any person

> directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange --
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative device or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988).

10. Rule 10b-5 provides that it is unlawful for any person

> directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any

(continued...)

ful to misrepresent or omit material information in connection with the purchase or sale of securities. 17 C.F.R. § 240.10b-5 (1991). To state a claim under § 10(b) and Rule 10b-5, a private plaintiff must plead (1) a false representation of (2) a material (3) fact, (4) the defendant's knowledge of its falsity and his intention that the plaintiff rely on it, (5) the plaintiff's reasonable reliance on the representation, and (6) the plaintiff's resulting loss. *Lewis v. Chrysler Corp.*, 949 F.2d 644, 649 (3d Cir. 1991).

1 *Rule* 12(b)(6)

As we have noted, the thrust of the complaint is that UJB and the individual defendants misrepresented the true status of the company's loan loss reserves, financial health, lending practices, and internal controls. The district court found that many of the alleged misrepresentations or omissions involved either failures to predict or mismanagement —not fraud—and were not actionable under the federal securities laws.

The basis for the district court's decision was *In re Craftmatic Sec. Litig.*, 890 F.2d 628 (3d Cir. 1990), where we held that "[w]here the incremental value of disclosure is solely to place potential investors on notice that management is culpable of a breach of faith or incompetence, the failure to disclose does not violate the securities laws." *Id.* at 640. In *Craftmatic* we provided an extensive review of the Supreme Court's jurisprudence on materiality,[11] noth-

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10. (...continued)
person,

in connection with the purchase or sale of any security

17 C.F.R. § 240.10b-5 (1991).

11. An omitted fact is material if there is a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). In other words, the issue is whether there is a substantial likelihood that the disclosure would have been viewed by the reasonable investor as having "significantly altered the 'total mix' of information" available to that
(continued...)

ing that the courts are "reluctant to permit a federal securities claim to stand when the plaintiff has failed to allege more than nondisclosure of mismanagement." *Id.* at 639.

Because it plays such a prominent role in the complaint, we will briefly discuss the nature of a loan loss reserve, which is defined in the banking trade as a

> statement of condition, or balance sheet, account set up by a bank based on its expectations about future loan losses. As losses occur, they are charged against this reserve. That is, the loan account is credited and the reserve account is debited. The reserve is established by a debit to an expense account called the loan loss provision, with a corresponding credit to the loan loss reserve.

American Bankers Association, *Banking Terminology* 215 (1989). There appears to be no single method of evaluating and setting loan loss reserves, perhaps because no method has proven foolproof. C. Edward McConnell, *Loan Loss Reserve Management and Unwise Lending Practices, in Bank Credit* 354 (Herbert V. Prochnow ed. 1981). Some banks set their loan loss reserves by comparing the size of the reserves to that of the loan portfolio. *See* Keith G. Turman, *Evaluating a Bank's Loan Loss Reserve Adequacy*, Internal Auditor, February 1991, at 5253. Others also analyze the quality of their loans in varying degrees of detail and according to a range of different criteria and classifications. *See, e.g., id.*; Ronald A. Stollers, *Loan Loss Reserve Analysis: Is It Moving From Art to Science?*, Banking Policy Report, April 1, 1991, at 4; Francis X. Conway & William A. Stegenthaler, *Loan Loss Reserves:*

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11. (...continued)
investor. *Craftmatic*, 890 F.2d at 639. Materiality is a mixed question of law and fact, and the delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts are peculiarly for the trier of fact. *TSC*, 426 U.S. at 450. Only if the alleged misrepresentations or omissions are so obviously unimportant to an investor that reasonable minds cannot differ on the question of materiality is it appropriate for the district court to rule that the allegations are inactionable as a matter of law. *Id.*

Tax, Regulatory, and Adequacy Issues, J. of Com. Bank Lending, Sept. 1987, at 4; Victor F. Ptasznik, *Another Approach to Calculating the Loan Loss Reserve*, J. of Com. Bank Lending, April 1987, at 7; Jerry Abner, *Calculating the Loan Loss Reserve from a Watch List*, J. of Com. Bank Lending, August 1985, at 2. All techniques, however, require quantitative and qualitative analyses of the past and present status of loans. *See* Conway & Stegenthaler, *Loan Loss Reserves, supra*, at 9 ("Relying on standardized, nondiscretionary formulas to aid in the determination of loan loss reserves is oversimplifying a complex problem."); *see also* Allowance for Loan and Lease Losses for Federal Branches and Agencies, Office of Comptroller of the Currency, Banking Circular 201, Fed. Banking L. Rep. (CCH) ¶ 51,132 (May 31, 1985) (describing minimum assessment customarily undertaken by soundly managed banks). No matter what method is used, the economic judgments made in setting loan loss reserves can be validated only at some future date. McConnell, *supra*, at 354-55.

There is nothing unique about representations and omissions regarding loan loss reserves that removes them from the purview of the antifraud provisions of the federal securities laws. In our view a reasonable investor would be influenced significantly by knowledge that a bank has knowingly or recklessly hidden its true financial status by deliberately misstating its level of non-performing loans, failing to provide adequate reserves, and indulging its problem loan customers. *See In re Midlantic Corp. Shareholder Litigation*, 758 F. Supp. 226, 234 (D.N.J. 1990). On the other hand, mere failure to provide adequate reserves (or to perform competently other management tasks) does not implicate the concerns of the federal securities laws and is not normally actionable. Similarly, if a defendant has not commented on the nature and quality of the management practices that it has used to reach a particular statement of loan loss reserves, earnings, assets, or net worth, it is not a violation of the securities laws to fail to characterize these practices as inadequate, meaningless, out of control, or ineffective. *Craftmatic*, 890 F.2d at 633 n.5 & 640 (dismissing allegations that defendants failed to disclose general subjective assessments of controls, organization, and management information systems).

However, where a defendant affirmatively characterizes management practices as "adequate," "conservative," "cautious," and the like, the subject is "in play." For example, if a defendant represents that its lending practices are "conservative" and that its collateralization is "adequate," the securities laws are clearly implicated if it nevertheless intentionally or recklessly omits certain facts contradicting these representations. Likewise, if a defendant characterizes loan loss reserves as "adequate" or "solid" even though it knows they are inadequate or unstable, it exposes itself to possible liability for securities fraud. By addressing the quality of a particular management practice, a defendant declares the subject of its representation to be material to the reasonable shareholder, and thus is bound to speak truthfully.

Our decision that such general labels as "conservative" and "cautious" can be the basis for liability under Rule 10b-5 is supported by the Supreme Court's recent decision in *Virginia Bankshares, Inc. v. Sandberg*, ___ U.S. ___, 111 S. Ct. 2749 (1991). In that case, the executive committee and board of directors of a bank approved a merger proposal that would pay its minority shareholders $42 per share. The directors solicited proxies for voting on the proposal at the company's annual meeting. In the solicitation sent to minority shareholders, the directors stated that the merger was an opportunity to achieve a "high" value at a "fair" price. *Id.* at ___, 111 S. Ct. at 2756. After the merger was approved, the plaintiff filed a complaint alleging violations of SEC Rule 14a-9, which prohibits the making of false or misleading statements of material fact in —and the omission of material facts necessary to make existing statements not false or misleading from—a proxy statement. 17 C.F.R. § 240.14a-9 (1991). Specifically, the plaintiff alleged that the directors had not in fact believed that the price offered was "high" or that the terms of the merger were "fair."

The Supreme Court rejected the defendants' argument that statements of opinion or belief were not "material." After noting that a fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote, the Court commented that

> there is no room to deny that a statement of belief by corporate directors about a recommended course of action, or an explanation of their reasons for recommending it, can take on just that importance. Shareholders know that directors usually have knowledge and expertness far exceeding the normal investor's resources, and the directors' perceived superiority is magnified even further by the common knowledge that state law customarily obliges them to exercise their judgment in the shareholders' interest.

Id. at ____, 111 S. Ct. at 2757.

If a director's statement of belief is material because of the speaker's superior knowledge, then a manager's statement of belief must also be material. A manager's knowledge and expertise regarding the day-to-day operation of his company generally exceeds that of a director, and the reasonable investor is aware of this fact. Even if management sometimes acts in its own interest, a reasonable investor need not take a manager's statement of belief at anything less than face value.

Virginia Bankshares also rejected the argument that statements of reasons, opinions, or beliefs are not "factual" for purposes of the securities laws. Such statements, said the Court, "are factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed." *Id.* at ___, 111 S. Ct. at 2758.

> Reasons for directors' recommendations or statements of belief are . . . characteristically matters of corporate record subject to documentation, to be supported or attacked by evidence of historical fact outside a plaintiff's control. . . .
>
> . . . .
>
> It is no answer to argue, as petitioners do, that the quoted statement on which liability was predicated did not express a reason in dollars and cents, but focused instead on the 'indefinite and unverifiable' term, 'high' value, much like the similar claim that the merger's terms were 'fair' to shareholders. The objection ignores the fact that *such conclusory terms in a commercial context are reasonably understood to rest on a*

> *factual basis that justifies them as accurate, the absence of which renders them misleading*. Provable facts either furnish good reasons to make a conclusory commercial judgment, or they count against it, and expressions of such judgments can be uttered with knowledge of truth or falsity just like more definite statements, and defended or attacked through the orthodox evidentiary process that either substantiates their underlying justifications or tends to disprove their existence.

Id. at ___, 111 S. Ct. at 2758-59 (emphasis added). For these reasons, plaintiffs here are "permitted to prove a specific statement of reason knowingly false or misleadingly incomplete, even when stated in conclusory terms." *Id.* at ___, 111 S. Ct. at 2759. We believe that the evaluations of management practices and financial well being alleged here are as conclusory (and as provable) as those in *Virginia Bankshares*.

In this case, plaintiffs accuse defendants of knowingly or recklessly misrepresenting that they thought UJB's:

- loan loss reserves were "adequate," "adequately maintained," "strong," and "solid" (¶ 52 (a), (b), (c), (e));

- loan portfolio was "well secured," "well collateralized," and of a high "quality" (¶ 52 (d));

- loan to value ratio was "good" (¶ 52(d));

- loan management and underwriting practices were "conservative," "basic," "careful," "good," "prudent," and "cautious," (¶ 52(e));

- asset quality was "high," while their level of bad loans was "low" (¶ 52(d), (g)); and

- internal controls not only existed, but were properly centralized, supervised, and managed (¶ 52(f), (g), (h)).

Moreover, plaintiffs allege that the published figures relating to earnings, assets, and net worth were knowingly or recklessly "overstated and inflated." ¶ 52(a). In light of our discussion, all of these statements, if made knowingly or recklessly, are actionable.

Nevertheless, not all the allegations made in paragraph 52 are actionable. As we have noted, it is not a violation of the securities laws to simply fail to provide adequate loan loss reserves; properly collateralize or secure a loan port-

folio; or provide sufficient internal controls or loan management practices.

Moreover, as the district court recognized, some of the pivotal allegations charge defendants with essentially failing to predict the future. As we pointed out previously, "where an event is contingent or speculative in nature, it is difficult to ascertain whether the reasonable investor would have considered the omitted information significant at the time. *Craftmatic*, 890 F.2d at 643 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 232 (1988) (internal quotation marks omitted)). For example, plaintiffs allege here that UJB failed to reveal that the loan loss reserves were inadequate in light of the "high risk of non-collectibility" (¶ 52(c)); and that UJB "would be" required to add substantial amounts to its loan loss reserves in the future (¶ 52(g)). Plaintiffs do not, however, allege that defendants possessed or made affirmative forecasts regarding these possible outcomes. *See Craftmatic*, 890 F.2d at 644. Thus, there is no allegation that defendants omitted "soft information" that can, in some circumstances, be actionable. *Flynn v. Bass Bros. Enterprises*, 744 F.2d 978 (3d Cir. 1984). For this reason, these particular allegations contained in subparagraphs 52(c) and (g) were properly dismissed.[12]

Having established the applicable principles of law, we would ordinarily leave it to the district court to evaluate the remaining paragraphs and subparagraphs of the complaint, including the balance of paragraph 52. However, plaintiffs' style of pleading has made it difficult to parse the complaint, primarily because many of the actionable allegations were intermingled with the inactionable. Moreover, the

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12. Our discussion of the strengths and weaknesses of paragraph 52 also applies to the preceding and succeeding paragraphs. Some of these allegations can, under the principles announced, be the basis for a § 10(b) claim. Others suffer from the defects already identified. For example, paragraph 25 alleges that a UJB quarterly report included a statement that "United Jersey looks to the future with great optimism." This allegation is clearly inactionable puffing. Moreover, many allegations refer to defendants' statements about specific figures. If these statements were material misrepresentations, they may be actionable; if they were merely the product of mistakes in calculation, they are not.

manner of pleading obscures what plaintiffs are in fact alleging. For example, subparagraph 52(c) alleges that UJB's "total loan reserves, particularly reserves for construction loans, were not maintained at an adequate level." This language, taken in isolation, is plainly an allegation of inactionable mismanagement. The preamble to paragraph 52, however, states that defendants made "untrue statements of material facts," and then lists several allegations, including subparagraph 52(c). It is difficult to discern whether plaintiffs are alleging that defendants made material statements that the reserves were adequate when in fact they were not, or whether plaintiffs are merely alleging that the reserves were inadequate. We are also troubled by certain syntactical problems. For example, subparagraph 52(a), in conjunction with the prefatory text, states:

> These included, among other things, the following: that the earnings, assets, and net worth of UJB were improperly and materially overstated and inflated throughout the Class Period due to grossly inadequate provisions for loan loss reserves.

It is difficult to comprehend this allegation. We do not believe that plaintiffs are alleging that the overstatement and inflation was caused by inadequate provision of loan loss reserves, yet this is what the paragraph appears to say. Similar ambiguities occur elsewhere.

Given the procedural history of this case, we would not ordinarily be disposed to offer plaintiffs yet another opportunity to revise their complaint. However, in light of the confusion that pervades plaintiffs' allegations, we conclude that the entire complaint must be reorganized. Therefore, on remand plaintiffs should rearrange the existing allegations into discrete units that are, standing alone, each capable of evaluation under the legal principles we have set forth. Because of the procedural history here, plaintiffs may not add to the existing factual allegations in making their revisions. We also note that plaintiffs in future cases of this kind should plead clearly and coherently from the outset.

2. Rule 9(b)

Rule 9(b) requires a plaintiff to plead (1) a specific false representation of material fact; (2) knowledge by the person who made it of its falsity; (3) ignorance of its falsity

by the person to whom it was made; (4) the intention that it should be acted upon; and (5) that the plaintiff acted upon it to his damage. *Christidis v. First Pennsylvania Mortgage Trust*, 717 F.2d 96, 99 (3d Cir. 1983). Despite these stringent requirements, the courts should be "sensitive" to the fact that application of the Rule prior to discovery "may permit sophisticated defrauders to successfully conceal the details of their fraud." *Id.* at 99-100. They should also respect the "general simplicity and flexibility" of the Federal Rules of Civil Procedure. *Id.* at 100.

In *Christidis* we dismissed allegations that defendants knew or should have known that loan loss reserves were understated, improperly used and led to distortions of other financial data. Such allegations, we stated, could only succeed if, when the loan loss reserves were established, "the responsible parties knew or should have known that they were derived in a manner inconsistent with reasonable accounting practices." 717 F.2d at 100. We found the allegations deficient because they had not disclosed "the manner in which, in establishing reserves for bad debts in the financial statements relied upon, defendants knowingly departed from reasonable accounting practices." *Id.* Despite three amendments, plaintiffs had failed to state "[w]hat those practices are and how they were departed from." *Id.*

In *Craftmatic*, however, we recognized that:

> Particularly in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs. Thus, courts have relaxed the [particularity] rule when actual information is peculiarly within the defendant's knowledge or control.

890 F.2d at 645 (citations omitted). Nevertheless, we also held that at the very least plaintiffs must allege that the necessary information lies within defendants' control. *Id.* Although acknowledging that plaintiffs here cannot be expected to plead with specificity the details of UJB's internal corporate practices, the district court dismissed the remaining allegations for failure to allege defendants' exclusive control over this information. The complaint does not specifically allege that defendants have exclusive control of

information plaintiffs require.[13]

Had the complaint contained a boilerplate allegation that plaintiffs believe the necessary information "lies in defendants' exclusive control," it still would not have satisfied Rule 9(b). As we have noted, even under a more relaxed application of the rule, plaintiffs must accompany such an allegation with a statement of facts upon which their allegation is based. *Craftmatic*, 890 F.2d at 645; *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 540 (9th Cir. 1989); 2A James W. Moore & Jo D. Lucas, *Moore's Federal Practice* ¶ 9.03[1] at 9-29 to 9-29 (1991) ("where the facts are in the exclusive possession of the adversary, courts should permit the pleader to allege the facts on information and belief, provided a statement of the facts upon which the belief is founded is proffered"). To avoid dismissal in these circumstances, a complaint must delineate at least the nature and scope of plaintiffs' effort to obtain, before filing the complaint, the information needed to plead with particularity. This requirement is intended to ensure that plaintiffs thoroughly investigate all possible sources of information, including but not limited to all publicly available relevant information, before filing a complaint. We will allow plaintiffs another opportunity to meet this

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13. The allegations cited by plaintiffs do not allege that the necessary information lies exclusively within defendants' control. Brief of Appellant Shapiro at 40 n.13. Rather, they allege only that defendants had access—but not exclusive access—to company information when the alleged misrepresentations and omissions occurred. *See* Complaint ¶ 6 (alleging that individual defendants had "access" to non public information at the time of the alleged misstatements and omissions); ¶ 51 (alleging that "[t]he true financial and operating condition of UJB, which was known or recklessly disregarded by defendants, remained concealed from the investing public" during the class period); ¶ 53 (alleging that defendants "could have obtained" knowledge of the facts during the Class period); and ¶ 58 (alleging that the plaintiffs would not have bought UJB securities during the Class period if they had known of materially adverse information "which was not disclosed by defendants").

standard.[14] Accordingly, we will reverse the district court's dismissal of subparagraphs 52(d), (e), (h) and (i) on Rule 9(b) grounds.

B. §§ *11 and 12(2)*

Count II alleges that UJB's Dividend Reinvestment and Stock Purchase Plan ("the DRISP") and the accompanying prospectus and registration statement were false and misleading, and that plaintiffs purchased UJB stock "pursuant to" all three documents.[15] Under the DRISP, shareholders

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14. Despite our reversal of the district court's dismissal on Rule 12(b)(6) grounds of subparagraphs 52(a), (b), (c), (f), and parts of subparagraphs 52(d) and (e), defendants urge us to affirm the dismissal on Rule 9(b) grounds. We leave it to the district court to evaluate in the first instance the particularity of these allegations.

The district court also dismissed Court II, which alleges that defendants violated §§ 11, 12(2), and 15, "to the extent that it relies on the points raised in" paragraph 52. Slip op. at 7. Our analysis with respect to Count I of the materiality and particularity of the fact allegations made in that paragraph also applies to Count II.

15. The key paragraphs of Count II are:

> 61. Class Plaintiff Jerome Katz, who purchased UJB's common stock during the Class period pursuant to the Company's Dividend Reinvestment Plan, bring [sic] this Count against defendant UJB on behalf of those members of the Class who purchased during the Class Period the Company's common stock pursuant to the DRISP prospectus.
>
> 62. In connection with the sale of the Company's common stock pursuant to the DRISP prospectus, defendant UJB was the 'seller' of such stock, within the meaning of Section 12(2) of the Securities Act of 1933.
>
> 63. The DRISP prospectus offering and describing the securities of UJB was false and misleading, *inter alia*, in the particulars previously described.
>
> 64. In ignorance of the false and misleading nature of the representations described above, members of the Class purchased UJB securities issued pursuant to the foregoing registration statements and prospectuses.

(continued...)

reinvested their dividends by purchasing additional UJB shares. *See* App. at 438. Some of these new shares were authorized but previously unissued treasury stock, but others were purchased by UJB in the secondary market. *Id.*

1. *Rule 12(b)(6)*

a. § *11*

Under § 11 of the Securities Act, any person acquiring a security issued pursuant to a false or misleading registration statement may recover damages. *See* 15 U.S.C. § 77k. Plaintiffs allege that they purchased UJB stock "pursuant to" a DRISP registration statement. The district court dismissed this claim, holding that although plaintiffs need not prove their shares are traceable to a false or misleading registration statement at this early stage of the litigation, they must allege it. We agree that traceability must be alleged, but our review of plaintiffs' complaint leads us to conclude that this has been done.

If plaintiffs' shares were purchased in the secondary market, they would not be linked to a registration statement filed during the class period, and the § 11 claim would fail. Before discovery takes place, however, it is impossible for plaintiffs to know whether their shares were newly issued or were purchased in the secondary market. The complaint alleges that the shares were purchase "pursuant to" the DRISP. At some point, plaintiffs may be able to prove that their DRISP shares came from treasury stock. Because we cannot say that plaintiffs can prove no set of facts that would entitle them to relief, the § 11 claim cannot be dismissed at this time.

b. § *12(2)*

Section 12(2) provides that a person who "offers or sells" securities by means of a prospectus or oral communication that misrepresents or omits material facts is liable to the person "purchasing such security from him." 15 U.S.C. § 771 (1988). The district court dismissed the § 12(2)

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15. (...continued)

The remaining paragraphs of Count II allege damage and petition for relief.

claim, finding insufficient plaintiffs' allegation that defendants were "sellers" within the meaning of the statute.

In *Pinter v. Dahl*, 486 U.S. 622 (1988), the Supreme Court held that the term "seller" under § 12(1) is not limited to the person who passes title to the security, but includes anyone "who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." *Id.* at 647. In *Craftmatic* we extended *Pinter* to § 12(2). We interpreted *Pinter* as having held that

> the term "solicitation" does not encompass all activities related to the purchase transaction . . .
>
> . . . .
>
> Thus, although an issuer is no longer immune from § 12 liability, neither is an issuer liable solely on the basis of its involvement in preparing the prospectus. The purchaser must demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller.

890 F.2d at 636. We upheld allegations that each defendant "either sold [the] securities directly to plaintiffs . . . or solicited plaintiffs . . . and in so acting were motivated by a desire to serve their own financial interests or the financial interests of the owner(s) of [the] securities." *Id.* at 637.

Plaintiffs' complaint briefly describes the DRISP and alleges that "[i]n connection with the sale of the Company's common stock pursuant to the DRISP prospectus, defendant UJB was the 'seller' of such stock, within the meaning of § 12(2)." The district court held that this allegation was defective because plaintiffs must demonstrate "direct and active participation in the solicitation of the immediate sale." It found no factual allegation specifying how UJB had directly and actively participated in the immediate sale,and noted that the mere preparation of a prospectus was insufficient under *Craftmatic*. We disagree.

These plaintiffs were not required to allege that UJB directly "solicited" the sales. The *Pinter/Craftmatic* solicitation rule applies only when the defendant issuer is not in direct privity with the purchaser. *Pinter* adopted solicitation liability as an expansion of the restrictive view that § 12

extended only to sellers in direct privity. 486 U.S. at 644. In *Craftmatic*, because the securities were purchased from an underwriter acting as a middleman, the defendant was not in privity with plaintiffs. Here, however, the newly offered shares purchased through the DRISP were sold directly to plaintiffs by UJB. *See* App. at 438 ("Purchases of UJB Common Stock may be made directly from UJB or on the open market, at the discretion of senior management of UJB.").[16] Because plaintiffs need not allege that UJB directly and actively participated in solicitation of the purchase,[17] they have adequately alleged that UJB was a "seller" within the meaning of § 12.

2. *Rule 9(b)*

The district court held that the § 11 and § 12(2) allegations in Count II "sounded in fraud" and that Rule 9(b) applies. We agree.

Count II incorporates by reference all preceding factual allegations, including those delineating defendants' "intent." It also states that the DRISP prospectus was false and misleading "in the particulars previously described," and

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16. Because the DRISP prospectus provided that the shares would be purchased either directly from UJB or on the open market, the district court dismissed the § 12(2) claim because of plaintiffs' failure to "trace" their securities to an initial public offering. Our earlier analysis of traceability applies here. We therefore assume (for purposes of defendants' motion to dismiss) that plaintiffs' shares did not come from the secondary market, and that plaintiffs have sufficiently traced their shares to the DRISP prospectus. If defendants were eventually to prove that the shares came from the secondary market, § 12(2) would not apply, and judgment would be entered for them. *Ballay v. Legg Mason Wood Walker, Inc.*, 935 F.2d 682 (3d Cir.), *cert. denied*, ____ U.S. _____, 112 S. Ct. 79 (1991).

17. While we believe that plaintiffs should have alleged that UJB was a "direct" seller, they did allege that they bought their stock "pursuant to the DRISP prospectus." It is reasonable to infer from this allegation that plaintiffs did not purchase their shares through an intermediary. Judge Becker would hold that the present allegation is inadequate and that plaintiffs should have alleged specifically that UJB was a "direct" seller.

mentions the false and misleading nature "of the representations described above." Complaint ¶¶ 62-63. Although Count II does not allege fraudulent intent or recklessness (a prerequisite to a successful fraud claim), neither does it allege negligence. The specific factual allegations upon which Count II is based do, however, repeatedly aver that defendants "intentionally," "knowingly," or "recklessly" misrepresented and omitted to represent certain material information. For example, paragraph 53, which expressly purports to characterize all of the complaint's factual allegations, asserts that:

> Each of the defendants, by action as hereinabove described, did so knowingly or in such a reckless manner as to constitute a willful deceit and fraud upon plaintiffs and the members of the Class. With knowledge or reckless disregard of the true financial and operating condition of UJB, the Individual Defendants caused the reports, statements and releases, to contain misstatements and omissions of material fact as alleged herein . . .

Complaint ¶ 53. The only reasonable conclusion that can be drawn is that plaintiffs charge defendants with fraud. There is not a hint in the allegations that defendants were negligent in violating §§ 11 and 12(2).[18]

Plaintiffs contend that because Count II does not mention the intent required for fraud, we must necessarily infer that the claims are grounded in negligence. As defendants point out, however, Rule 9(b) refers to "averments" of fraud, and thus requires us to examine the factual allega-

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18. Buried in paragraph 13, which avers that common questions of law and fact predominate, is a brief mention of "whether the defendants acted willfully, recklessly or with gross negligence in omitting and/or misrepresenting material facts or in aiding and abetting the making of misstatements." It would be unreasonable to infer a negligence cause of action from this fleeting and obscure reference to "gross negligence." *Cf. United States v. Dunkel*, 927 F.2d 955, 956 (7th Cir. 1991). This conclusion is confirmed by plaintiffs' failure to cite to paragraph 13 when arguing that their § 11 and § 12(2) claims sound in negligence rather than fraud. *See* Brief of Appellant Katz at 9-18.

tions that support a particular legal claim. Plaintiffs also maintain that their incorporation by reference of earlier factual allegations should not "contaminate" Count II. We agree that a pleader should not be penalized for economizing. Here, however, only one paragraph preceding Count II refers to the DRISP. Quite simply, plaintiffs did not allege ordinary negligence there or anywhere else.

Moreover, we are not presented with a "mixture of allegations of negligence, fraud, and the misleading nature of" certain communications. *In re Consumers Power Co. Sec. Litig.*, 105 F.R.D. 583, 594 (E.D. Mich. 1985). As we have noted, the complaint is devoid of allegations that defendants acted negligently in violating §§ 11 and 12(2). Instead, it brims with references to defendants' intentional and reckless misrepresentation of material facts. We see no way to construct a negligence cause of action here.

Next we determine whether Rule 9(b) applies to § 11 and § 12(2) claims grounded in fraud, a question not yet decided in this court. *See Craftmatic*, 890 F.2d at 645 n.28 (leaving question open with regard to § 12(2)). It is clear that neither fraud nor mistake is a necessary element of either statutory cause of action. Under § 12(2) defendants may be held liable for negligent misrepresentation or omission. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 687-88 (3d Cir. 1991); *Craftmatic*, 890 F.2d at 645 n.28 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 208-09 (1976). The same is true of § 11. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983). By its plain wording, Rule 9(b) would not appear to apply to claims that a defendant negligently violated §§ 11 and 12(2); we need not and do not decide this issue. On the other hand, the plain language of the rule clearly encompasses § 11 and § 12(2) claims based on fraud like those before us. *See, e.g., Sears v. Likens*, 912 F.2d 889, 892-93 (7th Cir. 1990) (applying Rule 9(b) to § 12(2) claim). We see no valid reason to create a special exception to Rule 9(b) for such claims. Accordingly, we hold that when § 11 and § 12(2) claims are grounded in fraud rather than negligence, Rule 9(b) applies.

The district court did not address whether plaintiffs' § 11 and § 12(2) allegations were pleaded with sufficient particularity. Although we will remand for full considera-

tion of this issue, we offer the following guidance. The most serious flaw in the § 11 claim went unnoticed by the parties. Section 11 imposes liability for false or misleading statements made in "registration statements." 15 U.S.C. § 77k (1988). Paragraph 61 of the complaint alleges that Katz and those he represents purchased UJB stock pursuant to a DRISP "prospectus," not a registration statement. A prospectus generally makes up the bulk of the registration statement, contains nearly identical information, and serves many of the same disclosure purposes. However, it is a distinctly separate document under the federal securities laws. Paragraph 64 alleges that members of the class purchased UJB stock "pursuant to the foregoing registration statements," but no reference to a registration statement precedes paragraph 64. Indeed, paragraph 33 of the complaint describes the issuance of only a "prospectus" in connection with the DRISP. Thus, these allegations, even if true, do not provide even the "short and plain statement of the claim showing that the pleader is entitled to relief" required by Rule 8(a)(2), let alone the notice required by Rule 9(b).

The § 12(2) claim does identify the offending prospectus, but is only slightly more informative than the § 11 allegations. The complaint neither identifies which allegedly false statements violated § 12(2) nor explains how they were false. Under Rule 9(b), a plaintiff must allege the manner in which a defendant knowingly departed from the truth. *Christidis*, 717 F.2d at 100. As already noted, we are sensitive to the fact that premature application of Rule 9(b) can permit sophisticated defrauders to conceal fraud. *Id.* at 99-100. We are also aware that in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs. *Craftmatic*, 890 F.2d at 645. Nevertheless, "even under a non-restrictive application of the rule, pleaders must alleged that the necessary information lies within the defendants' control, and their allegations must be accompanied by a statement of the facts upon which the allegations are based." *Id.* The district court should, on remand, evaluate the particularity of the § 11 and § 12(2) claims in light of these comments.

C. *Negligent Misrepresentation*

The district court dismissed plaintiffs' supplementary state law claim for negligent misrepresentation, holding that

New Jersey law does not extend this cause of action to the general investing public. We disagree.

Under New Jersey common law, persons who negligently misrepresent material facts may be held liable to those who, as a result of their justifiable reliance on such misrepresentation, suffer economic harm. *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 142-43 (N.J. 1983). In *Rosenblum* the New Jersey Supreme Court held that a buyer of stock may sue a corporation's outside auditor for negligent misrepresentations regarding the corporation's financial statements. In an exhaustive discussion, the court rejected the view that the plaintiff must be in privity with the auditor. Instead, "the independent auditor . . . has a duty to all those whom that auditor should reasonably foresee as recipients from the company of the statements for its proper business purposes." *Id.* at 142; *see also id.* at 146.

Rosenblum takes an expansive view of the range of permissible plaintiffs in a negligent misrepresentation action. It explicitly rejects the majority view that the plaintiff must be in privity, and adopts the more inclusive "reasonably foreseeable plaintiff" rule. There is no dispute here that the average investor was a reasonably foreseeable recipient of defendants statements about UJB. Defendants argue instead that investment by the general public is not a "proper business purpose." To state the argument is to note its defects. As one court has explained,

> Defendants . . . seek to parse out a subtle distinction between a "business decision" and an "investment decision." These terms . . . distinguish between an audit statement sent directly to an institutional investor to induce an investment and audit reports released to the general public for the same purpose. The contention is that the former investors are covered under the negligent misrepresentation doctrine while the ordinary public investor remains unprotected. *Rosenblum* makes no such distinction between these classes of reasonably foreseeable plaintiffs.

In re Midlantic Shareholders Litig., 758 F. Supp. 226, 237

n.9 (D.N.J. 1990).[19] Indeed, the *Rosenblum* court expressly stated that information sent to stockholders could be the basis of liability:

> When the defendants prepared the Giant audit, they knew . . . that it was to be incorporated in Giant's annual report, a report that would be transmitted to each Giant stockholder. . . . The defendants also knew or should have known that the audited financial statements would be available and useful for *other proper business purposes*, such as public offerings of securities . . .

461 A.2d at 154 (emphasis added). Moreover, the court looked to the expansive liability under the federal securities laws as a model for New Jersey law. *Id.* at 151. Therefore, it is not accurate to say that *Rosenblum's* "business purpose" requirement limits the cause of action to those who make "significant" investments.

In sum, we find that the New Jersey Supreme Court intended to part company with the majority of states that allow only plaintiffs who are in direct privity to sue for negligent misrepresentation. Therefore, we hold that this cause of action extends to foreseeable individual investors who, as a result of their reliance on negligently made misrepresentations, suffer economic loss.[20]

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19. At least four other district courts have held that New Jersey provides a negligent misrepresentation cause of action to the investing public. See *Urbach v. Sayles*, No. 91-1291, 1991 WL 236183 at *10-*11 (D.N.J. Sept. 4, 1991); *Gatman v. Howard Sav. Bank*, Fed. Sec. L. Rep. (CCH) ¶ 95,631 (D.N.J. 1990); *Bernstein v. Crazy Eddie, Inc.*, 702 F. Supp. 962, 982 (E.D.N.Y. 1988); *Kronfeld v. First Jersey Nat'l Bank*, 638 F. Supp. 1454, 1467 68 (D.N.J. 1986). *But see Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989).

20. In *Rosenblum*, the court commented that the negligent misrepresentation cause of action

> applies by its terms only to those foreseeable users who receive the audited statements from the business entity for a proper business purpose to influence a business decision of

(continued...)

D. *Security*

Under § 11(e) of the Securities Act, a district court "may, in its discretion, require an undertaking for the payment of the costs of [a Securities Act] suit, including reasonable attorney's fees."[21]

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20. (...continued)

> the user, the audit having been made for that business entity. Thus, for example, an institutional investor or portfolio manager who does not obtain audited statements from the company would not come within the stated principle. Nor would stockholders who purchased the stock after a negligent audit be covered *in the absence of demonstrating the necessary conditions precedent.*

Id. at 153 (emphasis added). It is not clear what the court meant by "the necessary conditions precedent." Perhaps it refers to reliance and the other elements of the cause of action. In any event, it is plain that *Rosenblum* does not foreclose liability to everyday investors.

Defendants also rely on *Karu v. Feldman*, 574 A.2d 420 (N.J. 1990), a post *Rosenblum* case. This reliance is misplaced. Although *Karu* found that the plaintiff did not state a claim for negligent misrepresentation, the decision did not turn on privity or the "business purpose" requirement. Rather, the court held that the defendant bank had not acted negligently because it had not provided certain false information to a depositor and had no duty to disclose other information. *Id.* at 427 28. *Karu* may support a finding that UJB had no duty to disclose certain information under New Jersey law, but it in no way supports the contention that a member of the investing public has no cause of action.

21. Section 11(e) provides:

> . . . In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorneys' fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit . . . to have been *without merit*, in an amount sufficient to reimburse him for the reasonable ex-

(continued...)

The principal purpose of § 11(e) is to deter plaintiffs from bringing meritless actions solely to procure a favorable settlement. *Phillips v. Kidder, Peabody & Co.*, 686 F. Supp. 413, 416 (S.D.N.Y. 1986); *see also Hochfelder*, 425 U.S. at 211 n.30. Defendants concede that § 11(e) security is typically required "when the plaintiffs' action 'borders on the frivolous' *or* 'is brought in bad faith.'" Brief of Appellees at 55. The district court made no finding that Katz' claims met either of these standards. As we have seen, many of these claims are sufficient to withstand a motion to dismiss. Therefore, we will vacate the district court's security requirement.

IV. CONCLUSION

For the reasons stated, we will affirm in part and reverse in part the district court's dismissal of Counts I and II and remand for proceedings consistent with this opinion. Moreover, we will affirm the district court's decision that Rule 9(b) applies to the § 11 and § 12(2) claims,[22] but will remand for further determination of the sufficiency of the applicable allegations. We will also reverse the district court's dismissal of Count III. Finally, we will vacate the district court's order insofar as it requires class representative Katz to post security.

Each side shall bear its own costs.

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21. (...continued)

penses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

15 U.S.C. § 77k(e)(1988)(emphasis added).

22. The district court dismissed Count II's § 15 claim because the § 11 and § 12(2) claims to which it attached had been dismissed. In light of our revival of the latter claims, we will reinstate the § 15 claim for further consideration by the district court.

A True Copy:

Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY

IN RE: UJB FINANCIAL CORP. SHAREHOLDER LITIGATION	:	MASTER FILE
	:	Civil No. 90-1569 (AET)
THIS DOCUMENT RELATES TO ALL ACTIONS	:	ORDER

For the reasons stated in this court's opinion of January 22, 1991, and upon consideration of the papers submitted, and for good cause

It is therefore on this 12th day of February, 1991

ORDERED that defendant's motion to dismiss the consolidated amended complaint be and hereby is granted in part and denied in part, in the following manner:

(1) Counts I and II are dismissed to the extent that they rely on ¶¶ 52 (a), (b), (c), (f), and (g) of the amended complaint, and to the extent that they rely on allegations of mismanagement in ¶¶ 52 (d) and (e) of the amended complaint. The claim in Count II for relief under § 15 of the Securities Act is dismissed. Counts III and V are dismissed;

(2) Plaintiffs are given thirty days from the date of this order to amend: Counts I and II, to the extent that they rely on the allegations in ¶¶ 52 (d), (e), (h) and (i), in order to comply with FED. R. CIV. PRO. 9(b); and the claims in Count II under §§ 11 and 12(2) of the Securities Act in order to comply with FED. R. CIV. PRO. 12(b)(6) and this court's opinion of January 22, 1991. To the extent that plaintiffs do not submit these amendments within thirty days, the court will entertain a renewed motion to dismiss;

(3) Plaintiffs claim in Count I under § 20(a), and Count IV are not dismissed;

and it is further

ORDERED that putative class plaintiff Katz, who seeks to assert a claim under sections 11 and 12 of the

Securities Act, provide security pursuant to such Act in the amount of $50,000.00 within five days of the date of this order, and it is further

ORDERED that the putative derivative plaintiff Chappaqua Family Trust provide security pursuant to N.J.S.A. section 14A:3-6 in the amount of $50,000.00 within five days of the date of this order.

ANNE E. THOMPSON, U.S.D.J.

UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY
CIVIL ACTION NO. 90-1569 (AET)

IN RE: :
UJB FINANCIAL CORP. : TRANSCRIPT OF OPINION
SHAREHOLDER LITIGATION :

Monday, January 22, 1991
Federal Courthouse
Trenton, New Jersey

BEFORE: THE HONORABLE ANNE E. THOMPSON, U.S.D.J.

APPEARANCES:

BARRACK, RODOS & BACINE, ESQUIRES
BY: LEONARD BARRACK, ESQUIRE
ANTHONY BOLOGNESE, ESQUIRE
-and-
GREENFIELD & CHIMICLES, ESQUIRES
BY: LISA J. RODRIGUEZ, ESQUIRE
On behalf of Plaintiffs

EUGENE A. SPECTOR & ASSOCIATES
BY: PAUL SCARLATO, ESQUIRE
On behalf of Derivative Plaintiffs

WILENTZ, GOLDMAN & SPITZER, ESQUIRES
BY: FREDERIC K. BECKER, ESQUIRE
-and-
WEIL, GOTSHAL & MANGES, ESQUIRES
BY: IRWIN H. WARREN, ESQUIRE
BETH J. JACOBWITZ, ESQUIRE
On behalf of Defendants

Vincent Russoniello, CSR, RPR
Official Court Reporter
U.S. District Court
District of New Jersey
138 Paxson Avenue
Trenton, New Jersey 08690
(609) 588-9516

Pursuant to Section 753, Title 28 USC, the following transcript is certified to be an accurate transcription of my stenographic notes in the above-entitled matter.

Vincent Russoniello, CSR, RPR

THE COURT: This matter arises on defendants's motion to dismiss the complaint pursuant to Rules 9(b), 12(b)(6), 12(b)(1), and 23.1 of the Federal Rules of Civil Procedure.

Plaintiffs, in their complaint, seek damages arising from the alleged overstatement of UJB's financial condition through mismanagement and inadequate loan reserves. Plaintiffs maintain that they relied on fraudulent statements when purchasing stock which was overvalued as a result of defendants' actions. The complaint is comprised of several separate counts. Count I alleges violation of § 10(b) of the Securities Exchange Act of 1934 and SEC rule 10b-5. Count II claims that defendants violated §§ 11, 12 and 15 of the Securities Act of 1933. Count III is a state law claim of negligent misrepresentation. Count IV charges proxy violations under § 14(a) of the Security Exchange Act. Finally, Count V alleges breach of fiduciary duty. Plaintiffs premise their claims on a lengthy set of factual allegations, set out in ¶¶ 1-46 of the complaint. Rather than conduct a lengthy review of these assertions of fact, the court will refer where appropriate to those specific facts necessary to analyze the motion.

Rule 12(b)(6)

Defendants seek to dismiss Counts I and II for failure to state a claim upon which relief may be granted. They argue that these counts are based on allegations of mismanagement, and as such are not cognizable under the 1933 or 1934 Acts.

Mismanagement alone is an insufficient basis on which to base a claim under either act. Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476-79 (1977); In re Craftmatic Securities, 890 F.2d 628, 638 n.14 (3d Cir. 1989). As well, claims based solely on "soft," speculative matters, such as failure to predict future performance, will not stand. Craftmatic at 640-44. "The Third Circuit has limited the application of the Santa Fe case . . . to those situations wherein plaintiffs do not allege material omissions or misstatements by defendants [which are] actionable under the securities laws." In re Avant-Garde Computing, Inc., Civ. No. 85-4149 (AET) at 14 (D.N.J. Sept. 5, 1989). Omissions or misstatements of mismanagement are not

actionable under security laws, however, where the essence of the claim alleges mismanagement, rather than misrepresentation. Craftmatic at 640.

Defendants argue that plaintiffs' claims amount to nothing more than mismanagement, deceptively framed as fraud claims. Plaintiffs counter that the claims are based on material omissions or misstatements concerning management policies and success, rather than on mismanagement itself. "[W]e must be alert to ensure that the purpose of Santa Fe is not undermined by 'artful legal draftsmanship;' [since] claims essentially grounded on corporate mismanagement are not cognizable under federal law." Craftmatic at 638-39 (emphasis added). Thus, we must determine the core nature of plaintiffs' factual allegations.

The issue revolves around the definition of "material facts." Only where the alleged mismanagement is material will the claim be cognizable. Determining what is material can be a difficult task.

> "The line between a material nondisclosure and the nondisclosure of mere mismanagement is often difficult to draw. Arguably, any action amounting to corporate mismanagement would be material . . . . However, courts have been reluctant to permit a federal securities claim to stand when the plaintiff has failed to allege more than nondisclosure of mismanagement. Where the incremental value of disclosure is solely to place potential investors on notice that management is culpable of a breach of faith or incompetence, the failure to disclose does not violate the securities acts." Id. at 639-40 (citations omitted).

Thus, we must examine each of the bases for Counts I and II in light of this vague standard, to determine whether they constitute material omissions or misstatements. Craftmatic provides some guidance. There, the court upheld the dismissal of claims that defendant failed to disclose that it was "unfocused" and "unable to manage" and that "its financial reporting and accounting controls [are] inadequate and ineffective." Id. at 640. These claims were essentially grounded in allegations of mismanagement, and as such did not involve "material" omissions. The court allowed claims, however, which were based on "the omission or

misrepresentation of information regarding Craftmatic's advertising, promotion, and marking program," where those activities were under investigation by several states. Id. at 646. These claims were based on specific omissions of facts which were material in nature.

Plaintiffs' factual allegations in Count I are contained in ¶ 52. Several of these claims, at their core, are nothing more than assertions of mismanagement. Others are a mixture of mismanagement and fraud, while some are fundamentally claims of fraud. The court finds that Count I is based on mismanagement rather than fraud so far as it relies on the following points:

> "[52](a) that the earnings, assets, and net worth of UJB were improperly and materially overstated in inflated . . . due to grossly inadequate provisions for loan loss reserves;
> (b) that the defendants caused UJB to continually understate its non-performing loans and failed to provide adequate loan loss reserves for problem loans promptly and properly, and instead granted extensions, further credits, and other beneficial terms to its problem loan customers . . . ;
> (c) that UJB's total loan loss reserves . . . were not maintained at an adequate level in light of the economic conditions . . .;[1]
> . . .
> (f) that, [sic] UJB's lending practices and controls were not sufficiently centralized, were unmanageable and UJB's commercial lending officers had engaged in high risk and speculative loan transactions, which were not being adequately supervised, controlled, or directed by higher management, contrary to defendants' representations . . .

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1. In Craftmatic, the court discussed "failure to predict" as a separate issue. That discussion centered around failure to release predictions to the public. Here, the crux of plaintiffs' claim is that defendants' failure to make predictions exhibited poor judgment, and so we deal with this claim as a management issue. See Craftmatic at 644. Under either analysis discussed in Craftmatic, however, this claim should be dismissed. Id.

(g) that UJB would be required to add substantial additional amounts to its loan loss reserves as a result of its lending practices, contrary to defendants representations . . . . [specific representations omitted]"[2]

In making this determination, the court notes that points (a), (b), and (c) did not even allege omissions or misstatements. Instead, they simply discuss specific ways in which defendants should have performed better. Further, while points (f) and (g) were presented in the context of fraud, the core of each point revolves around mismanagement. The alleged misstatements in (f) are only generally referred to. As well, defendants are not required "to place potential investors on notice that management is culpable of a breach of faith or incompetence." Craftmatic at 639-40. The specific representations referred to in (g) also do not rise to violations of the securities acts, because they only amount to speculative predictions. Id. at 640-44.

The following points present a mixed issue of fraud and mismanagement, so that Count I should be dismissed to the extent that it relies on those portions of the following points which revolve around mismanagement:

(d) that, [sic] many of UJB's larger problem loans . . . were not adequately collateralized or secure, contrary to defendants' representations that [representations omitted].

(e) that UJB's credit review and authorization standards and policies and system of internal controls to assure adequate collateralization and prompt recognition and accounting for problem loans were not conservative, were not functioning adequately or were being disregarded . . . contrary to defendants' representations that . . . . [representations omitted]"

Here, plaintiffs complain about defendants' business practices. However, they also present very specific references to claims made by defendants. Distinguishing between, for example, the allegedly inadequate collateralization and plaintiffs' reliance on assurances about collateralization, the

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2. Although points (f) and (g) are presented as if they alleged fraud, the core of each claim is mismanagement.

court finds that the former is an allegation of mismanagement which does not state a claim under the securities acts, whereas the latter does state a claim, since it asserts that defendants made omissions or misstatements of material facts.

Finally, the court finds that the points raised in 52(h) and (i) are allegations of misstatements or omissions, and should be allowed to remain. Accordingly, Count I is dismissed to the extent that it relies on the points raised in ¶ 52 (a), (b), (c), (f), and (g), as well as the allegations of mismanagement contained in ¶ 52 (d) and (e). All other portions of Count I raise a claim upon which relief may be granted, and will not be dismissed.

Count II is based on the same set of facts. See Complaint at ¶ 63. The court will therefore dismiss that count to the extent that it relies on the points raised in ¶ 52 (a), (b), (c), (f), and (g), and the allegations of mismanagement contained in ¶ 52 (d) and (e).

Defendants next argue that plaintiffs' securities claims in Counts I and II are too conclusory to satisfy Rule 12 (b) (6). While this position is not without merit, this court will refrain from dismissing the action at this point, in order to allow time for discovery. The court is motivated in part by the realization that many of the facts necessary to prove or disprove these allegations are largely within the peculiar knowledge of defendants.

Defendants also seek to dismiss the § 11 claim in Count II because the complaint fails to allege that the relevant securities were traceable to a registration statement alleged to be materially false or misleading. As plaintiffs point out, the complaint alleges that the shares at issue were purchased "'during the Class Period [from] the Company's common stock pursuant to the DRISP prospectus.'" Pl. brief at 34, quoting from Complaint at ¶ 61. However, defendants note that, under the DRISP prospectus, stocks may have been purchased in the secondary market, and therefore may not have been purchased during the class period. The court finds persuasive the following language from a case raising the same issues:

> "On this pleading it is by no means certain that any of the stock purchased by plaintiffs is traceable to the

> public offerings during the Class Period. Plaintiffs need not, of course, prove that their shares are traceable to the [challenged] offerings at this early stage of the litigation. But they must allege it." Bernstein v. Crazy Eddie, Inc., 702 F. Supp. 962, 972 (E.D.N.Y. 1988), vacated in part, In re Crazy Eddie, 714 F. Supp. 1285 (E.D.N.Y. 1989).

However, at this time the court will not dismiss the § 11 claim on this basis. Instead, the court will allow plaintiffs to amend their complaint to comply with the requirements of § 11. If plaintiffs do not amend within 30 days, the court will entertain a new motion to dismiss this particular claim.

Defendants argue that the § 12 claim contained in Count II should be dismissed because defendants are not "sellers" under the meaning of § 12(2). ¶ 62 of the complaint alleges: "In connection with the sale of the Company's common stock pursuant to the DRISP prospectus, defendant UJB was the 'seller' of such stock, within the meaning of Section 12(2) of the Securities Act of 1933." However, this bare allegation is not enough. See VT Investors v. R & D Funding Corp., 733 F. Supp. 823, 839 (D.N.J. 1990). Plaintiffs must "demonstrate direct and active participation in the solicitation of the immediate sale to hold the issuer liable as a § 12(2) seller." Craftmatic at 636 (emphasis added).

Here, there is no factual allegation which specifies how UJB "directly and actively participated" in the immediate sale, so that ¶ 62 of the complaint is too conclusory under Rule 12(b)(6). Garshaman v. Universal Resources Holding, Inc., 625 F. Supp. 737, 741 (D.N.J. 1986). Plaintiffs point to the DRISP prospectus which was prepared by UJB. However, mere preparation of a prospectus, without more, does not rise to a level of direct participation in the immediate sale. The court in Craftmatic found sufficient factual allegations in the complaint to deny the motion to dismiss. Specifically, the complaint alleged

> "[e]ach of the defendants . . . either sold said securities directly to plaintiffs . . . or solicited plaintiffs . . . to buy Craftmatic common stock . . . and they . . . conspired with and aided and abetted one another in connection with the preparation of the false and misleading Prospectus and Registration Statement used in

conjunction with the sale of Craftmatic securities."

Here, plaintiffs have alleged far less.

In addition, defendants argue that the § 12(2) claim should be dismissed for failure to allege that the stocks were "'issued pursuant to the defective prospectus.'" Def. brief at 27, citing Crazy Eddie, 702 F. Supp. at 972. Plaintiff relies on its reasoning in opposition to the motion to dismiss the § 11 claim. For the same reasons, the court agrees that plaintiffs have failed to state a claim upon which relief may be granted.

However, once again the court will give plaintiffs leave to amend their complaint to comply with both requirements under § 12(2), with the proviso that the court will entertain a new motion to dismiss this particular claim if plaintiffs do not amend within 30 days.

Defendants further argue that plaintiffs' § 15 claim, contained in Count II at ¶ 68, and their § 20 claim, contained in Count I at ¶ 59, should be dismissed for failure to state a "controlling person" claim. Plaintiffs argue that they have presented sufficient factual allegations to raise this claim in ¶¶ 6, 54, and 59 of their complaint. These paragraphs refers only to the individual defendants. The claim under § 15 is asserted in Count II. Since Count II is directed only at UJB, Complaint at ¶ 61, and since there is no factual allegation to support a "controlling person" claim against UJB, the § 15 claim is dismissed.

§ 20(a) of the Security Exchange Act of 1934 states:

> "Every person who, directly or indirectly, controls any person liable under any provision of this chapter or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable . . . ." 15 U.S.C. § 78t(a).

Defendants argue that plaintiffs "allege no facts reflecting culpable participation by any of the individual defendants . . . ." It may be true that "a mere showing of . . . status . . . does not automatically connote liability as a controlling person." Laven v. Flanagan, 695 F. Supp. 800, 808 (D.N.J. 1988). However, Laven dismissed the complaint after discovery was completed. Id. at 803.

This court finds persuasive the reasoning of In re Midlantic Corp., Civ. No. 90-1275 (DRD) (D.N.J. October 11, 1990). There, the court stated, "prior to discovery in any meaningful sense, plaintiff can hardly be able to plead the precise culpable conduct of each individual defendant." Midlantic at 22. The court also noted that this circuit "has 'given heavy consideration to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof.' " Id. (citing Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 890-91 (3d Cir. 1975). Thus, the court will not dismiss plaintiffs' claim under § 20(a) at this time.

Defendants next assert that plaintiffs' state law claim of negligent misrepresentation should be dismissed. Such a claim may be brought based on business reports where the plaintiffs "should reasonably [be] foresee[n] as recipients from the company of the statements for its proper business purposes . . . ." Rosenblum v. Adler, 93 N.J. 324, 352 (1983).[3] This district has read Rosenblum as an attempt to narrow the scope of this state law claim. "The argument might be made by plaintiffs that their decision to invest was a 'business decision,' and that the audit was performed for them in the sense that accountants' audit reports are prepared, and filed under the Exchange Act, with the purpose of, among other things, keeping investors informed. To conclude on that basis alone there is a negligence cause of action for the investing public generally, however, would be a liberal reading of Rosenblum." Cammer v. Bloom, 711 F. Supp. 1264, 1298-99 (D.N.J. 1989); see also id. at 1299 n. 57. Accordingly, this court will dismiss plaintiffs' third count.[4]

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3. Defendants also argue that this claim should be dismissed under Rule 12(b)(1) if the federal claims have been dismissed. Since the court has currently declined to dismiss all the federal claims, we will not dismiss this count under Rule 12(b)(1).

4. Plaintiffs cite to Midlantic for the proposition that negligent misrepresentation can be based on investor decisions. However, that court does not appear to have been presented with the issue raised in Cammer. Rather, defendants appear to have merely argued that "plain-

(continued...)

Defendants further argue that Count IV should be dismissed, because plaintiff Chappaqua has failed to allege all the necessary elements under § 14(a) of the Security Exchange Act. § 14(a) addresses omissions or misrepresentations in proxy statements. The complaint states that defendants should have revealed

> "the utter failure of the individual defendants . . . to cause UJB to disseminate reports to the investing public and to file with the SEC documents in full compliance with the federal securities laws, and to continue to cause the Company to overstate its earnings, assets and net worth by under-reserving for loan losses by at least $50 million or more, thereby causing the Company substantial losses, . . . as alleged in Counts I-III herein." Complaint at ¶ 81.

Defendants argue that this cause of action does not allege "transaction causation" as required under § 14(a). A similar argument was rejected by this district in Midlantic, Civ. No. 90-1275 at 20. There, plaintiffs' allegation was almost identically worded to the allegation in this case. Compare Midlantic at 20 with Complaint at ¶ 81. The court stated that "[t]he harm alleged here is that corporate directors were elected on the basis of materially false or misleading proxy statements. The causation alleged is perfectly clear on the face of the Complaint." Midlantic at 20.

Defendants argue that this count should be dismissed because plaintiffs fail to allege actionable misrepresentations. In Midlantic, "[t]he foundation of the defendants' argument [was] that the information they did not disclose was either a matter of mismanagement or too speculative and predictive and therefore is not actionable. Both these issues have been disposed of by this opinion in plaintiffs' favor . . . ." Midlantic at 20. Here, this court has determined that plaintiffs' fraud claims are actionable. Following the reasoning put forth in Midlantic, the court finds that Count IV is not an appropriate target at this time for a

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4. (...continued)
tiffs failed to allege the requisite reliance." Midlantic at 24. Thus, Midlantic is not helpful in the instant action.

motion to dismiss.[5]

Rule 23.1

Defendant argues that Count V should be dismissed because plaintiffs have not made a prelitigation demand, have not pled particularized facts showing that such a demand on the board is excused, and have not made a demand on UJB's shareholders. Fed. R. Civ. Pro. 23.1. Plaintiffs argue that they are excused from the prelitigation demand requirement.

Plaintiffs assert that "'the allegations of the complaint permit the inference by the court that the directors upon whom demand would be made lack the requisite disinterestedness to determine fairly whether the corporate claim should be pursued.'" Pl. brief at 42, citing Lewis v. Curtis, 671 F.2d 779, 785 (3d Cir. 1982), cert. denied 459 U.S. 880 (1982). Plaintiffs assert that they are exempt because a majority of the board are named defendants. However, this type of argument has been rejected by the courts. See Lewis at 785. Similarly, plaintiffs' arguments for exemption presented in ¶ 98 of their complaint are too speculative. Thus, it is not sufficient to allege, without particularized facts to back up the assertion, that the board "would refuse to take action with respect to these claims because any such action would require them to sue themselves, their friends, and their business associates." See id. Similarly, plaintiffs' allegation that the board is "dominated" by co-defendant Semrod is too conclusory, as is the assertions that the board participated in the wrongdoing, that the board is "self-interested," and that the board impliedly will not exercise proper business judgment on the issues presented because it has not acted in the past. See Landy v. FDIC, 486 F.2d 139, 148 (3d Cir. 1973) ("[t]hese allegations do not supply with particularity the reasons for failing to make the demand required by Rule 23.1"), cert. denied 416 U.S. 960 (1974). Accordingly, the fifth count will be dismissed.

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5. Because this court does not dismiss Chappaqua's federal claim, defendants' arguments that Chappaqua's state law claims should be dismissed under Rule 12(b)(1) cannot stand.

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Rule 9(b)

Defendant argues that the allegations raised in Counts I and II should be dismissed because plaintiffs have failed to plead with sufficient particularity the bases for their claims of fraud, as is required under Rule 9(b). Plaintiffs first argue that the rule does not apply to its §§ 11 and 12 claims. As noted by defendant, "[a]lthough an open issue in this Circuit, numerous courts have held that Rule 9(b) applies to claims under Sections 12 and 12 of the Securities Act where, as here, the complaint sounds in fraud." Def. brief at 12 (citation omitted). Rule 9(b) states that it is applicable to "all averments of fraud . . . ." Here, the remaining portions of plaintiffs' §§ 11 and 12 claims sound in fraud. Accordingly, Rule 9(b) applies by its clear wording.

This circuit has taken a narrow approach to Rule 9(b). "Courts must be sensitive to the fact that application of Rule 9(b) prior to discovery 'may permit sophisticated defrauders to successfully conceal the details of their fraud.'" Craftmatic, 890 F.2d at 645 (citing Christidis v. First Penn. Mortgage Trust, 717 F.2d 96, 99-100 (3d Cir. 1983).

Nonetheless, plaintiffs must present adequate pleadings to put defendants on notice of the basis of the claim. Kronfeld v. First Jersey Nat'l Bank, 638 F.2d 1454, 1463 (D.N.J. 1986). Here, plaintiffs have pled with great specificity the particular statements which are allegedly false, as well as when, where, and by whom those claims were made. Despite their assertions to the contrary, however, plaintiffs have not indicated with sufficient particularity how those statements are false. Christidis is instructive. There, the court dismissed an action on the basis of Rule 9(b) because the complaint did not set out the method and manner in which defendants' statements were contradicted by their actions. Christidis, 717 F.2d at 99, 100. Thus, ¶ 52(d) alleges that UJB's loans "were not adequately collateralized or secure, contrary to defendants representations . . ." without indicating how those loans were not adequately collateralized. In ¶ 52(h), plaintiffs do not indicate how "defendants failed to disclose the full truth regarding UJB's problems loans and lack of controls." The other

remaining claims in Counts I and II are similarly pled without sufficient particularity.

The Third Circuit tends to relax the application of Rule 9(b) "when factual information is peculiarly within the defendant's knowledge or control." Craftmatic at 645. "Particularly in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs." Id. However, as Craftmatic noted, "pleaders must allege that the necessary information lies within defendants' control, and their allegations must be accompanied by a statement of the facts upon which the allegations are based." Id. Here, such pleadings are lacking.

In keeping with the rest of this opinion, however, this court will give plaintiffs the opportunity to amend their complaint in order to comply with the requirements of Rule 9(b), especially in light of the fact that discovery is still ongoing. Once again, plaintiffs will have 30 days in which to submit their amended complaint, and the court will consider a motion to dismiss if plaintiffs fail to comply with this deadline.

For the reasons presented, defendants' motion to dismiss will be granted in part and denied in part. Further, plaintiffs are instructed to amend their complaint in order to comply with this court's instructions. The court orders counsel for defendants to submit a proposed order consistent with this opinion no later than Wednesday, January 30, 1991.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 91-5153

IRWIN SHAPIRO, on behalf of himself
and all others similarly situated

v.

UJB FINANCIAL CORP.;
T. JOSEPH SEMROD; and
JOHN R. HAGGERTY

Irwin Shapiro, Robert Bassman,
Jerome Katz, Norman Salsitz,
Jean Lee, Executrix of the
Estate of Calvin Lee, and
Chappaqua Family Trust

Appellants

(D.C. Civ. No. 90-01569)

SUR PETITION FOR REHEARING

Present: SLOVITER, Chief Judge, BECKER,
STAPLETON, MANSMANN, HUTCHINSON, SCIRICA,
COWEN, NYGAARD, ALITO and ROTH, Circuit Judges,
and VanARTSDALEN*, District Judge

The petition for rehearing filed by appellees in the above-entitled case having been submitted to the judges

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* As to panel rehearing only.

who participated in the decision of this Court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular service not having voted for rehearing, the petition for rehearing by the panel and the Court in banc, is denied.

BY THE COURT,

_____
Circuit Judge

Dated: July 7, 1992